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UKRAINE: COMPETING IN THE GLOBAL ECONOMY

STRATEGIES FOR SUCCESS

Highlights of the Report

January 2005

This publication was produced for review by the United States Agency for International Development. It was prepared by the BIZPRO Project, implemented by Development Alternatives, Inc.

ACKNOWLEDGEMENTS

This publication was made possible through support provided by the U.S. Agency for International Development (USAID) under the terms of Contract No. 121-C-00-00-00831-00.

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The team thanks Rick Gurley, Chief of the Private Enterprise Division, Office of Economic Growth, USAID Mission to Ukraine, Belarus and Moldova for his support and commitment.

The team expresses its gratitude to the American Chamber of Commerce in Kyiv and its members for meeting with the team and providing invaluable insight.

Last but not least, the team thanks the Ukrainian businesses and government officials who participated in this assessment.

ADDITIONAL REFERENCES

For more information about the state of small and medium-sized enterprises (SMEs) in Ukraine, please refer to BIZPRO's *National Survey*.

For practical information on how to invest in Ukraine, and specific information for investing in the tourism sector in the Carpathian Mountains, please consult BIZPRO's *Investor Roadmap of Ukraine*.

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The views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

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MEETING THE COMPETITIVENESS CHALLENGE

Since the beginning of its recovery in 2000, Ukraine's economy has demonstrated its resilience. Its pace of growth in 2004 put it in the upper tier of fast-growing economies worldwide. Although the recent growth figures may also capture some shift from the shadow to the formal economy, foreign trade has been a driving force in this resurgence. Soaring demand for Ukraine's traditional exports has boosted economic growth (both directly and indirectly) by stimulating an expansion of domestic demand. Leveraging the momentum from this expansion to reach into other sectors of the economy will be needed to meet the challenge of prospering in a market environment both at home and abroad, as a renewed commitment to the European Choice and a more aggressive pursuit of WTO accession further open the economy.

Responding to this market challenge will require the design and implementation of trade and competitiveness policies that move the economy beyond its traditional reliance on a narrow range of products. The first step in articulating a strategy to accelerate the pace of growth requires a rigorous appraisal of the overall policy framework for competitive performance of the economy in combination with an assessment of prospects and problems in key industrial clusters. Under the USAID-funded BIZPRO Project, a team of Ukrainian and foreign experts conducted a detailed appraisal of both policy aspects and performance prospects in selected clusters. A rigorous market orientation governs this appraisal: how is the Ukrainian economy doing in major markets? Given the openness of the economy, export markets set the standards.

Our assessment found that weaknesses in the enabling environment - in terms of both policy and institutions - raise transaction costs and undermine competitive performance. Three factors stand out in particular:

- *Policy design and implementation* raise the risk of investing and producing. The investment climate (as seen by both investors and analysts) lags far behind what is needed for rapid modernization of the economy. The administration of state functions adds needlessly to the cost of doing business. Moreover,

the poor investment climate also deters foreign direct investment (FDI) needed to promote innovation and integrate the economy into global value chains.

- *Market institutions* are generally feeble, and often oriented to serving the needs of yesterday's economy. Weaknesses in the country's quality infrastructure and market channels put the Ukrainian producer at a disadvantage long before the product reaches the consumer. The disruption of the traditional links between research and production has impaired the innovative capacity of the economy.
- *Key supporting industries*, the financial sector and information and communications technology in particular, have so far failed to provide the intermediation and support needed to promote innovation and investment.

Our appraisal suggests a number of specific actions to address these weaknesses. Virtually all of them stress the need for better public-private sector cooperation, whether in the preparations for WTO accession or in addressing deficiencies in market channels.

To examine the prospects for improving competitiveness in key clusters, the appraisal focused on Ukraine's nontraditional exports, that is, excluding such important commodities as steel and raw or semifinished goods. The selection was based on both the performance of various commodities in export markets and an independent assessment of key markets:

- information and communications technology (ICT);
- textiles and apparel;
- furniture;
- home furnishings;
- leather and footwear;
- construction materials;
- horticulture (complemented by a look at other agricultural exports);
- meat; and
- tourism in the Crimea and the Carpathian Mountains.

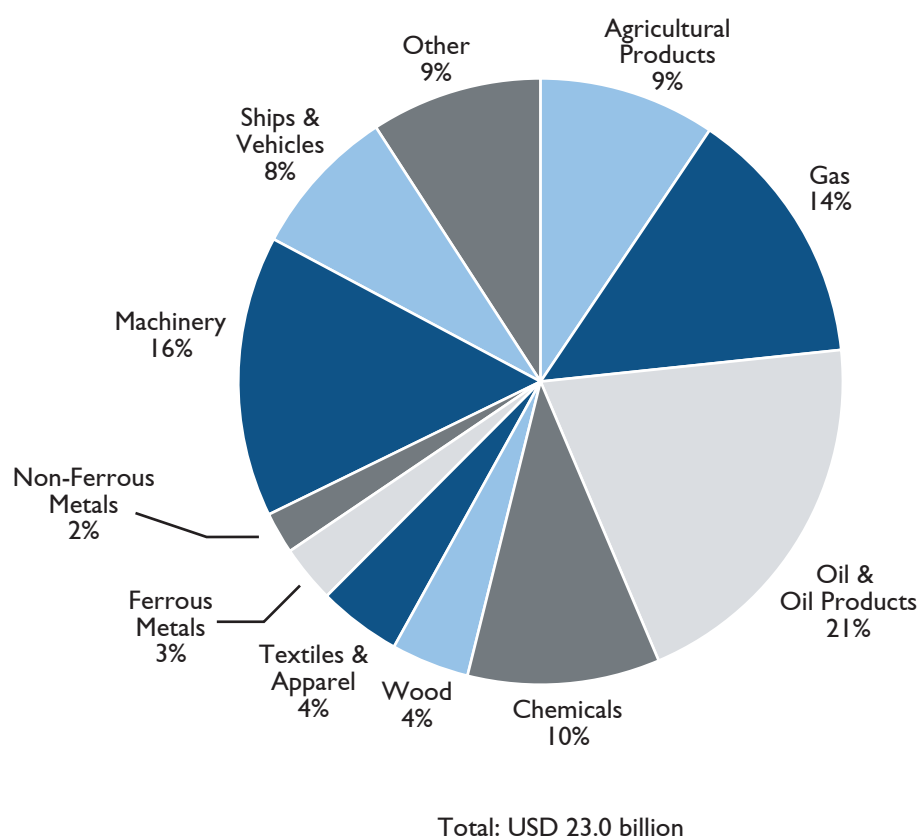
FOREIGN TRADE AS AN ECONOMIC DRIVER

TRADE COMPOSITION

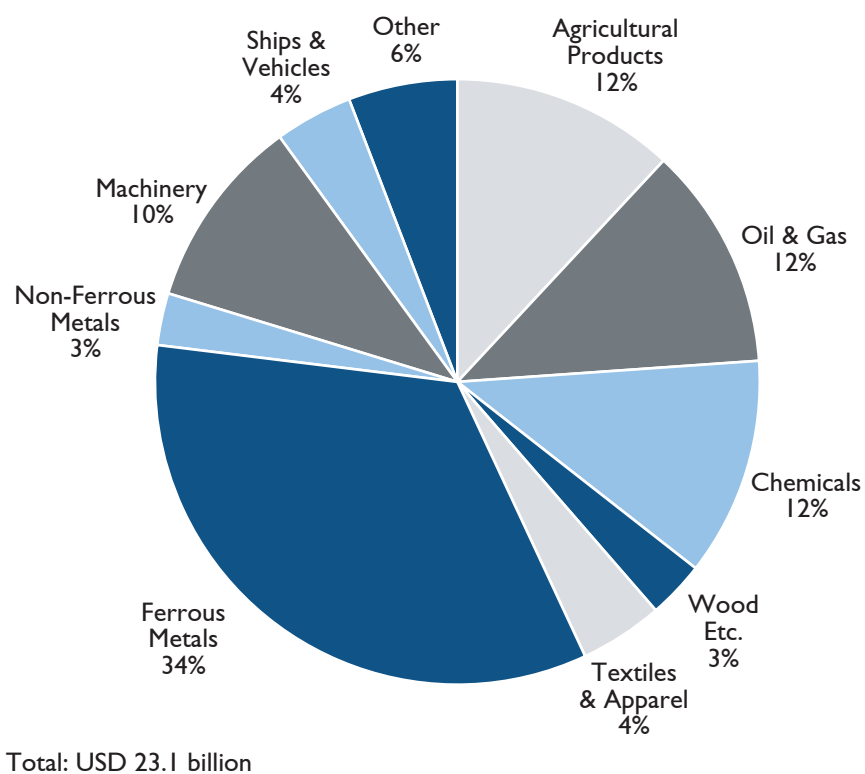
With a foreign trade turnover (exports plus imports) exceeding gross domestic product (GDP), Ukraine qualifies as an open economy when compared with Russia, Poland, or the EU, where the ratio is closer to 60 percent. Over the period 1999-2003, total merchandise exports increased by 125 percent (in dollar terms), with a higher percentage going to non-CIS countries. The recent export boom was helped in part by a real depreciation of the hryvnya relative to Western currencies; between June 2003 and June 2004, the real effective exchange rate depreciated by about 5 percent, in part as a result of the *de facto* peg to the dollar.

The import structure for Ukraine is dominated by energy, as shown in Figure 1. Gas and oil account for some 35 percent of the total, some of which is re-exported. On the export side (shown in Figure 2), ferrous metals dominate with 34 percent of the total. Agricultural products, re-exports of oil and gas, and chemicals each accounted for about 12 percent of the total. In other words, much of the recent expansion has been fueled by rapid economic growth among the country's trade partners which has translated into a rising demand for Ukraine's traditional exports.

FIGURE 1: THE COMMODITY STRUCTURE OF UKRAINE'S IMPORTS (2003)



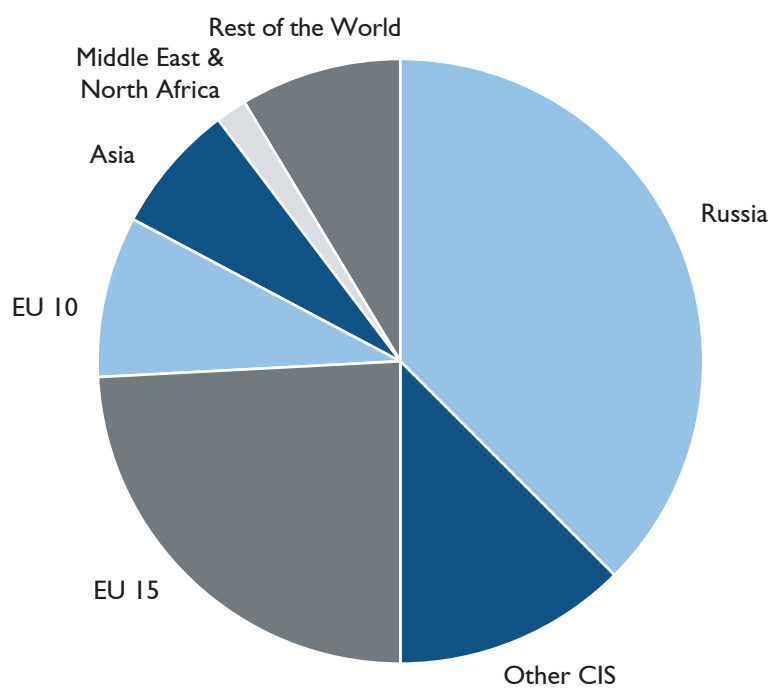
Source: Global Trade Atlas (www.gtis.com/gta); referred to as GTA below.

FIGURE 2: THE COMMODITY STRUCTURE OF UKRAINE'S EXPORTS (2003)

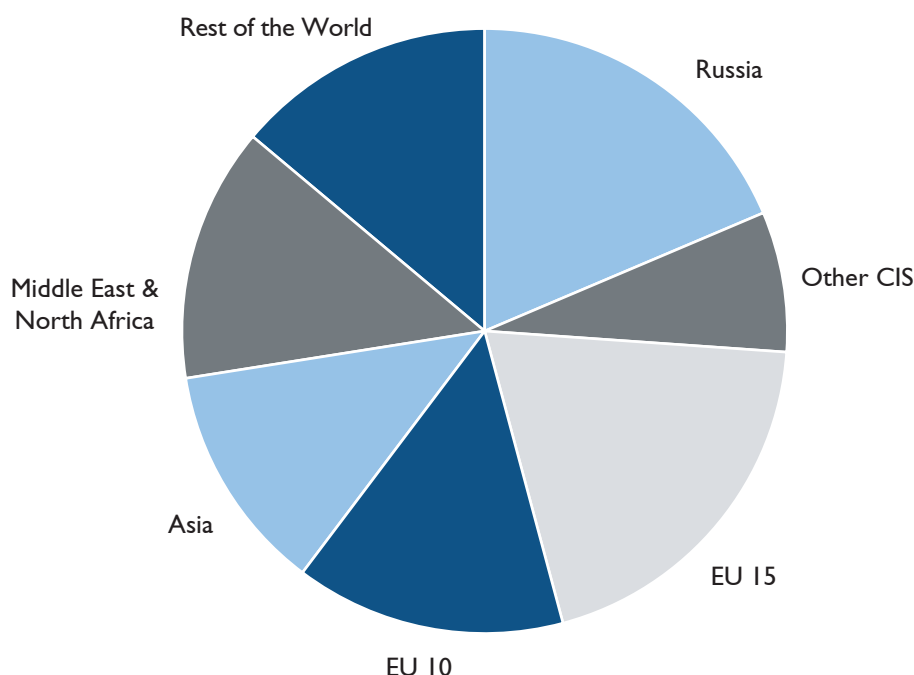
Source: GTA.

The recovery of trade has been accompanied by a clear shift to new markets. While the CIS remains the main source of

imports, it has been displaced by the expanded EU as the principal target for exports.

FIGURE 3: UKRAINE'S IMPORTS BY REGION/COUNTRY OF ORIGIN (2003)

Source: GTA.

FIGURE 4: UKRAINE'S EXPORTS BY REGION/COUNTRY OF DESTINATION (2003)

Source: GTA.

TRADE RELATIONS AND THE EU

While the “European Choice” is the official prime directive for trade policy, relations with other members of the CIS remain strong, reinforced by an apparent patchwork of trade agreements. Trade relations with the EU have not always been smooth, and prospects for reaching an arrangement that goes beyond the current Generalized System of Preferences (GSP) and Partnership and Co-operation Agreement (PCA) remain uncertain.

With the expansion of the EU on 1 May 2004, the European Union and Ukraine have become direct neighbors, yet Ukraine accounted for only a modest portion of total EU trade (0.5 percent for the EU 15 in 2002). In theory, trade with the EU 15 should account for roughly 40 percent of the country's trade. Obstacles exist on both sides. The EU has imposed quotas on steel imports from Ukraine, and has changed its policy in 2003 to impose high duties on cereals

imports from the East. Both restrictions are incompatible with WTO standards and will have to be revoked once Ukraine accedes to the WTO.

Although proximity to the expanded EU constitutes one of Ukraine's competitive advantages, trade patterns to date do not suggest that Ukrainian exporters have managed to use this opportunity to promote integration into the European economy. One of the problems here is the country's investment climate, which deters inflows of foreign direct investment critical to integrating the Ukrainian economy more effectively into global value chains. Quantitative indicators of trade integration suggest that Ukraine's economy remains fairly well integrated with its CIS trading partners, but its level of integration vis-à-vis the EU is one-third of the average level of an OECD economy.

A STRATEGIC VIEW OF COMPETITIVE EXPORT PERFORMANCE

One indicator of competitive performance in a given (export) market is the gain (or loss) of market share relative to the dynamics of the market itself, whether it is growing, remaining stagnant, or declining. The ideal configuration is to gain market share in a growing market which augurs well for the future; these commodities are the “rising stars.” Gaining market share in a stagnant or declining market may guarantee some market presence, since competitors are less inclined to invest in capturing market share; these commodities are “declining stars.” Losing market share in a growing market raises strategic issues of whether the loss warrants additional efforts with respect to competitors; such commodities are “missed

opportunities” or “shooting stars.” Finally, losing market share in a stagnant or declining market defines the respective commodities as “dark stars.”

Figure 5 and Figure 6 show these patterns for selected commodities, defined in terms of the Harmonized System (HS) used for Customs statistics. The focus of the analysis was on commodities for which enterprise growth interventions might conceivably matter. That approach precluded most of the raw materials and semifinished exports, including iron and steel. The x-axis shows the growth rate for the commodity relative to total imports by the EU or Russia; the y-axis denotes the growth rate in

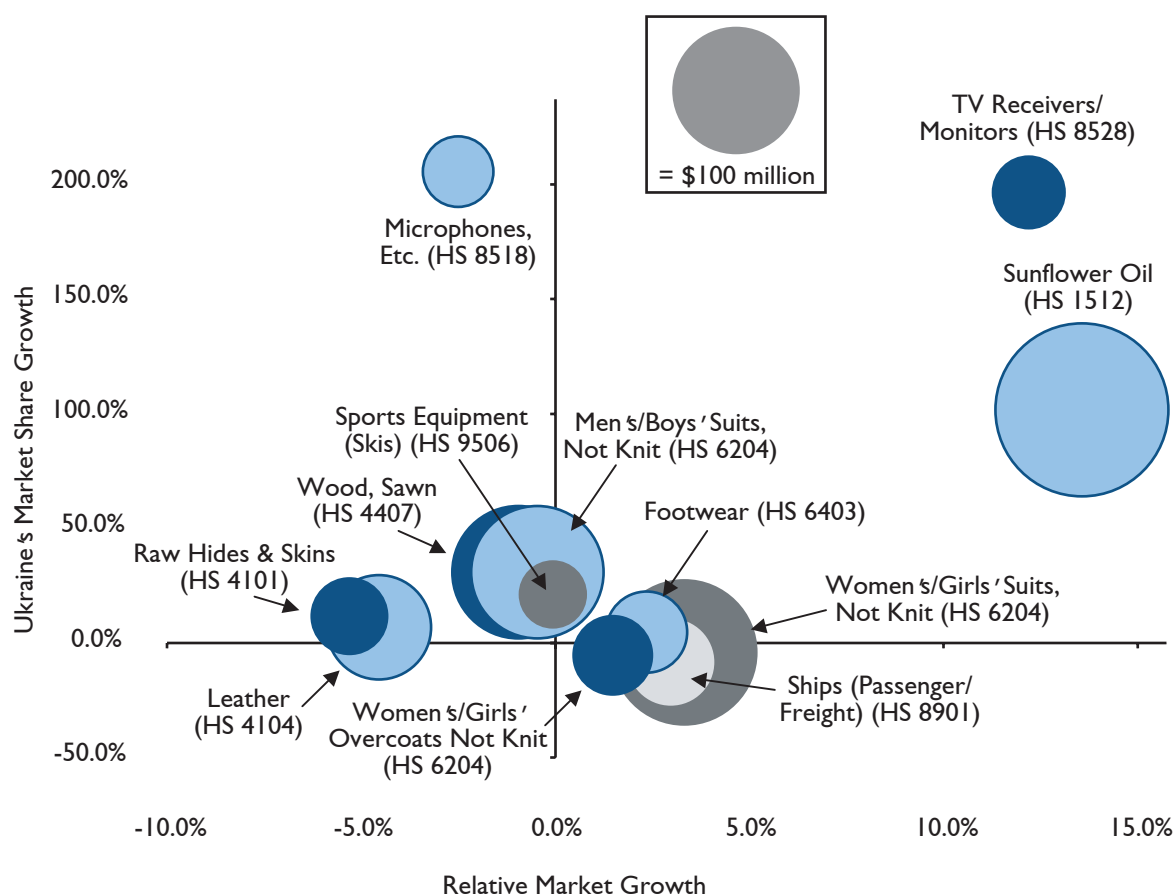
market share for exports from Ukraine. The size of the bubbles is proportional to 2003 exports in that commodity.

In the case of the EU, the principal rising star is sunflower oil. The other rising star (TV monitors) is likely to reflect an outsourcing arrangement, as is the leading declining star (microphones). The remainder of significant exports to the EU shows little dynamic performance. Three of the commodities shown belong to the leather cluster: raw hides and skins, leather, and footwear. The first two are gaining market share in a stagnant market, while footwear is a

“rising star.” Three of the remaining commodities are part of outward processing arrangements with the EU for apparel production, retaining market share in stagnant markets. Of the three remaining categories, wood (sawn) typifies the semifinished goods category, the position of ships reflects special orders that take advantage of installed capacity in Ukraine, and sports equipment appears to be the result of an arrangement with Austria to produce skis.

FIGURE 5: UKRAINE'S PERFORMANCE IN EU EXPORT MARKETS (1998-2003)

Selected Exports from Ukraine to the EU, 1998-2003

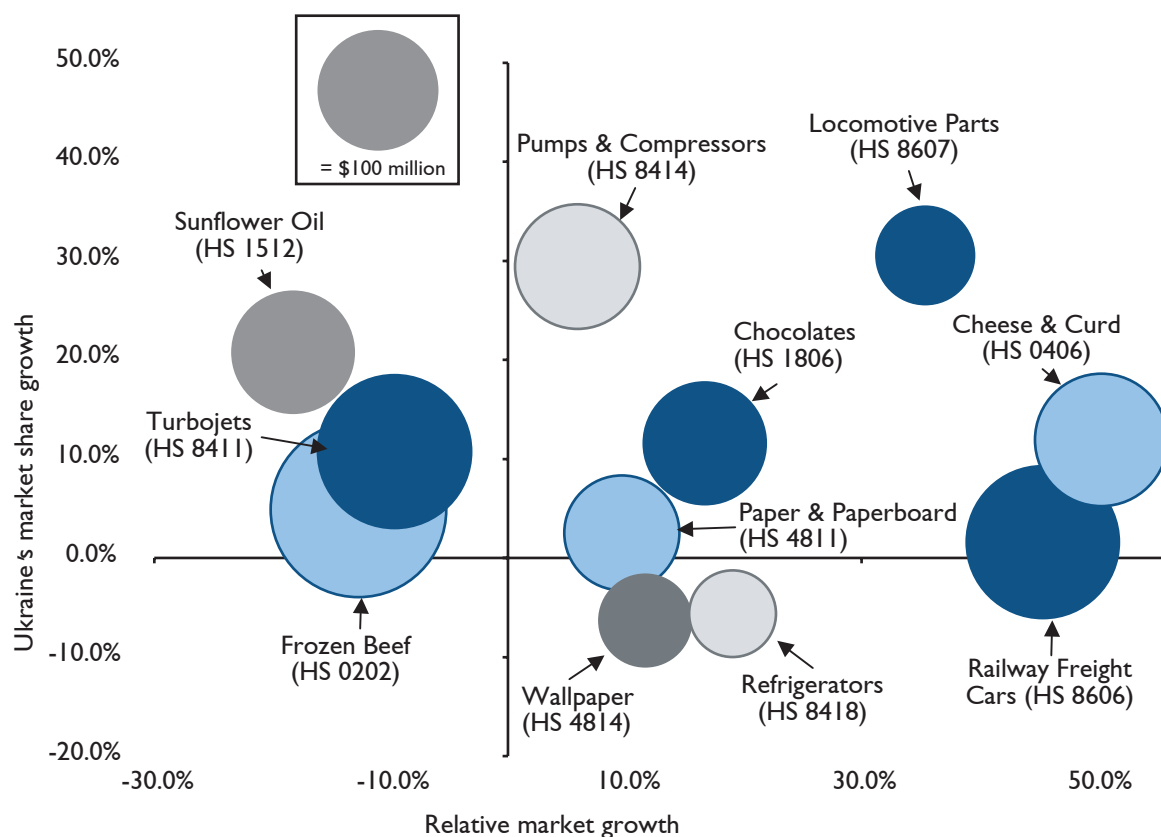


Source: GTA.

The patterns for exports to Russia are more diverse. They combine a wider variety of agricultural products (sunflower oil, frozen beef, chocolate, and cheese and curd) with machinery (turbojets, locomotive parts, pumps and compressors, and railway freight cars) and paper products.

Virtually all of the significant exports shown here are gaining market share. The exceptions ("shooting stars") are wallpaper and refrigerators. Frozen beef, turbojets, and sunflower oil represent the three "declining stars" in this analysis.

FIGURE 6: UKRAINE'S PERFORMANCE IN RUSSIAN MARKETS (1999-2003)



Source: GTA.

THE INVESTMENT CLIMATE

INTERNATIONAL BENCHMARKING TO SET STRATEGIC PRIORITIES

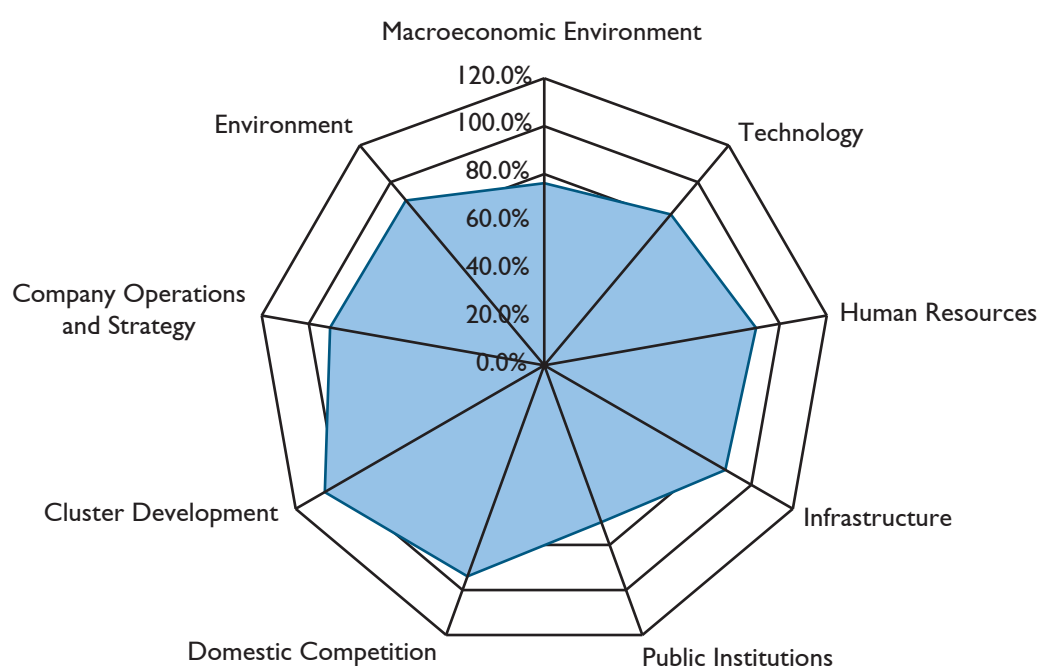
Many studies, workshops, and conferences have stressed the impact of deficiencies in the institutional infrastructure on economic growth in Ukraine. Lagging structural reforms have prevented domestic and foreign investors from responding fully to the opportunities created by an expanding export sector, often fueling imports instead. Overregulation, excessive interference, corruption, and the failure to ensure adequate physical and economic infrastructure impose significant costs on enterprises competing in either domestic or international markets. The weaknesses and uncertainties affecting domestic market architectures comprise major stumbling blocks to the progress of Ukraine's WTO accession. Though there have been some gains on the structural reform front, much remains to be done to transform Ukraine into a resilient market economy.

International benchmarking of the country's investment climate can be helpful in determining strategic priorities.

Although much is made of the overall standing or ranking of the country, what matters more is which areas deserve attention for intervention. Among the myriad business environment benchmarking studies, three recent cross-country comparisons provide an assessment of Ukraine's investment climate. First, the World Economic Forum's *Global Competitiveness Report* (GCR) ranks more than 100 countries in terms of various competitiveness indicators. A major part of this benchmarking exercise is based on the responses to an Executive Survey conducted in each of the countries included. The survey contains over 150 questions, grouped into nine sets of indicators. Figure 7 presents a comparison between the average scores for these nine sets of indicators for Ukraine and the average scores for the new EU members of Eastern Europe. The latter are set to 100 percent as a standard to gauge the relative strengths and weaknesses of the Ukrainian economy.

FIGURE 7: AVERAGE COMPETITIVENESS SCORES FOR UKRAINE COMPARED TO THE NEW EU MEMBERS

Ukraine's GCR scores relative to new EU members (2004)



Source: Comparison based on data from the Executive Survey *Global Competitiveness Report 2004-2005*. Some data was adjusted to ensure that a higher score is always better than a lower one.

The comparison shows that Ukraine's respondents rank the quality of public institutions lowest of all. The next-lowest relative score is for the macroeconomic environment. The average score here reflects both relatively high perceptions

of the macroeconomic situation and very low scores for items such as access to loans or satisfaction with Customs procedures (the lowest relative score of all questions). The highest overall score is for questions related to "cluster

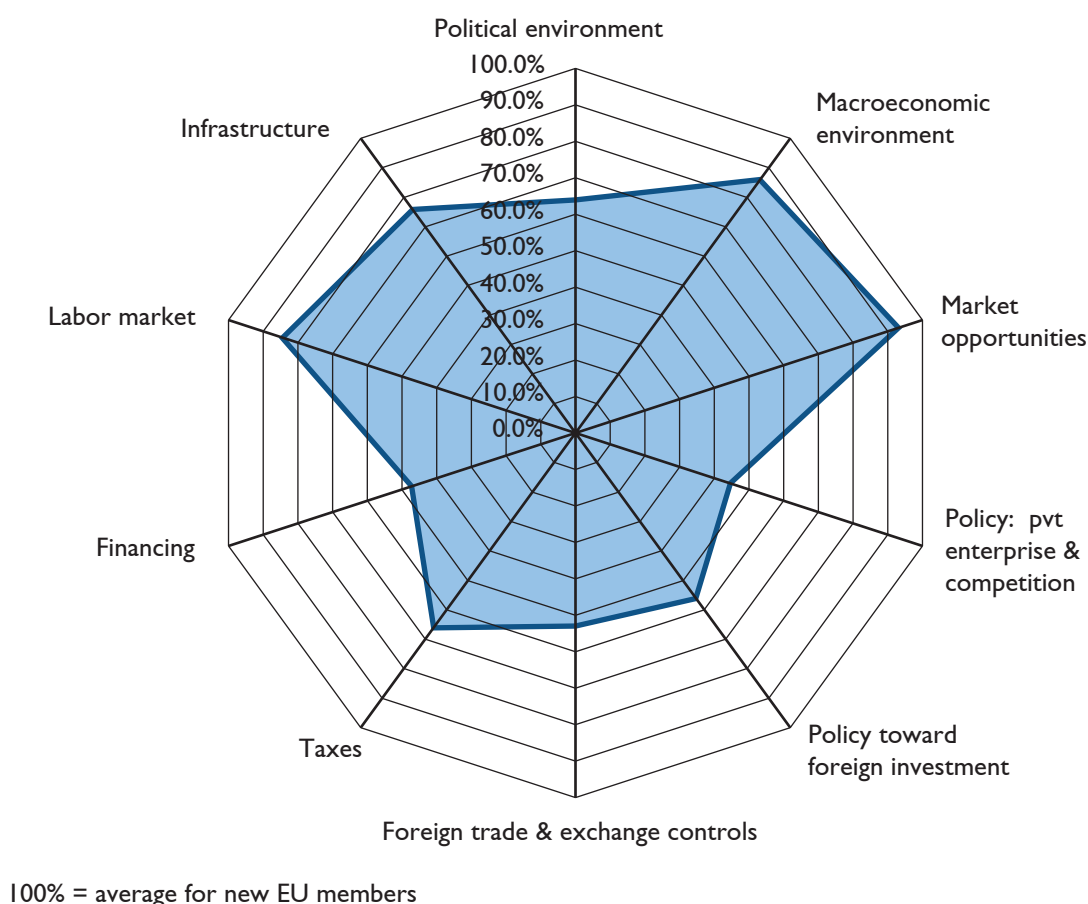
development,” where Ukrainian business executives rank Ukraine’s economy higher than the (average) business executive in a new EU member state ranks their respective economy on the same measure.¹

The World Bank’s renewed emphasis on the microeconomic foundations of enterprise growth as the basis for economic growth is reflected in the launch of its *Doing Business in 2004* (and now *Doing Business in 2005*) series. In the 2005 version, countries are ranked according to seven sets of indicators: starting a business, closing a business, enforcing contracts, protecting investors, getting credit, registering property, and hiring and firing workers. Ukraine’s average score for hiring and firing workers is almost double that for the new EU members. Ukraine also lags behind in terms of the average score for investor protection. The only set of indicators where Ukraine is competitive with respect to its neighbors to the west relates to contract enforcement.

Finally, the Economist Intelligence Unit (EIU) published an appraisal of the business environment in 27 transition economies in Eastern Europe and the CIS, and links these ratings to foreign direct investment levels. The ranking uses some 70 indicators grouped into 10 sets. Figure 8 presents the comparison of the average scores in each of these 10 sets to the corresponding average for the new EU members. The score for “market opportunities” is high because of the large size of the domestic economy. The two biggest gaps relative to the comparison countries are “policy toward private enterprise and competition” and “financing,” which echo the findings of the GCR comparisons in a more distinct form. Some of the stated gaps are being addressed by preparations for accession to the WTO; in other words, bringing the legal and regulatory system into compliance with WTO obligations will narrow many of these gaps.

FIGURE 8: UKRAINE'S BUSINESS ENVIRONMENT COMPARED TO THAT OF THE NEW EU MEMBERS

Relative EIU Scores, 1998-2002



Source: Comparisons based on rankings provided for 27 transition countries by the Economist Intelligence Unit.

The EIU rankings also provide a link to foreign direct investment. In the comparison of the 27 transition economies shown in Figure 9, Ukraine is characterized by one of the lowest FDI levels on a per capita basis and outranks only a few other CIS countries in terms of the

overall business environment score. This comparison of business environment rankings and FDI per capita suggests that the latter begins to respond to changes in the investment climate only past a certain threshold level. What is required to stimulate foreign direct investment (as well as

¹ While there are a number of attempts to ensure the comparability of findings of the Executive Survey across countries, the responses still reflect appraisals based on expectations. In other words, the responses here show different standards of what constitutes a high level of cluster development.

domestic investment) is a *significant* shift toward a more hospitable investment climate. Such a shift demands a concerted commitment from both the public and the private sector.

The picture emerging from these international comparisons highlights the importance of moving to a different policy

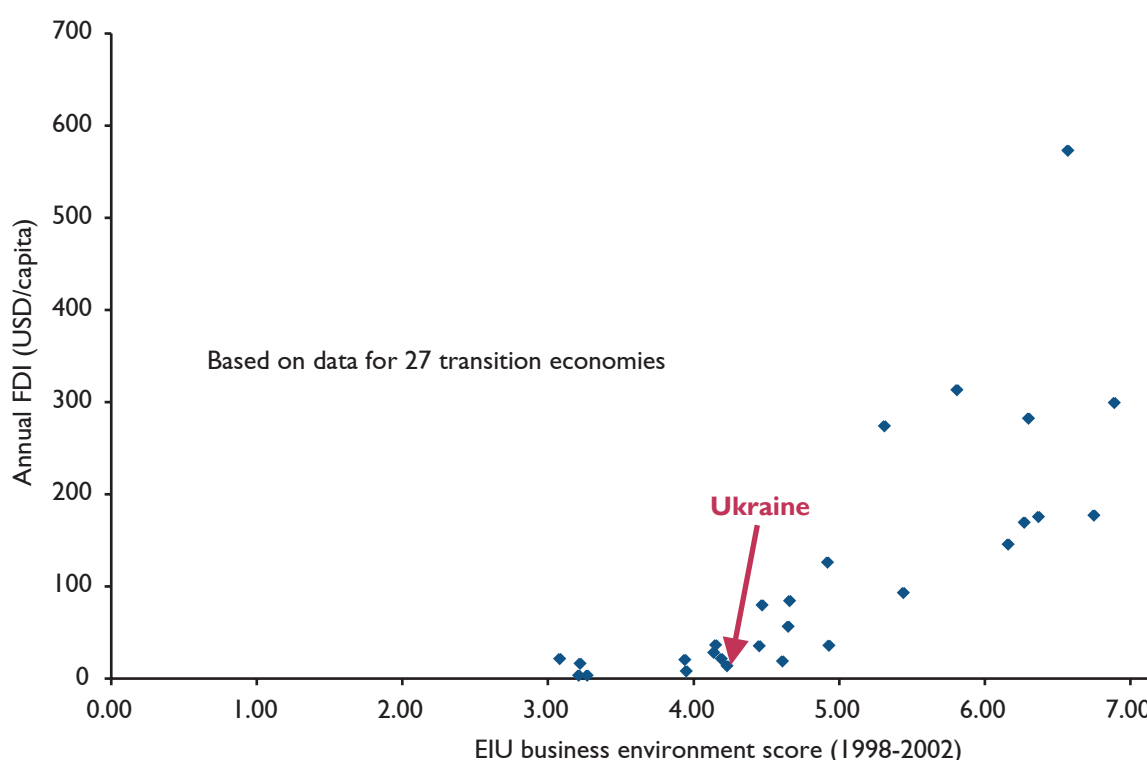
plane to strengthen and support the evolution of effective market architectures, and of the imperative to enhance and expand the country's financial system. These findings are a recurrent theme in this study.

WTO ACCESSION AND THE INVESTMENT CLIMATE

Accession to the WTO is ultimately not a goal in itself, but rather a tool for a new approach to conducting business in a global environment. Complying with WTO rules matters to other WTO members, but it does not automatically yield benefits to the Ukrainian economy. The countries that benefit most from accession use the process to engage in a

new and innovative approach to business practices. This process starts long before accession is granted, and really begins to take off once accession has been achieved. The critical challenge is to have the government and the private sector establish a working relationship that will last beyond the accession itself.

FIGURE 9: THE BUSINESS ENVIRONMENT AND FDI PER CAPITA



In Ukraine, the public sector to date has been fully responsible for handling the preparation for WTO accession, with little systematic involvement of the private sector. Efforts to build political impetus behind the accession drive are needed to prepare the country's economy to take advantage of the new opportunities and meet new competition. These efforts must respond to the concerns of other WTO members regarding problems with Ukraine's market architecture, characterized by high transaction costs because of government interventions, frequent changes in policy, lack of transparency, weak legal institutions, and

corruption. These deficiencies undercut the country's effective integration into the world economy, the ultimate purpose of WTO accession.

Preparations for WTO accession and improvements in domestic market architectures go hand in hand. Success ultimately depends again on close cooperation between the public and private sectors. Some efforts (such as the one by Microsoft to promote the adoption of legal software in Internet cafés) provide a model that can be emulated elsewhere.

MOBILIZING SCIENCE AND TECHNOLOGY FOR INNOVATION

SCIENCE AND TECHNOLOGY: AN ERODING STRENGTH

Ukraine's legacy in science and technology would seem to offer a sound base for fostering innovation by mobilizing market linkages. In a market economy, innovation is driven by private sector initiatives - but their success depends to a large degree on local policies and local institutions. The country's scientific research institutes, design bureaus, and state production enterprises constituted a major part of the Soviet military-industrial

complex. The last 12 years, however, have been marked by a deep and rapid erosion of the science and technology base. The total number of scientists engaged in basic or applied research has declined from 370,000 in 1992 to about 130,000 today. The culture of scientific inquiry remains, however, as do the institutions in the universities and national academies. But the "innovation engine" requires a major overhaul.

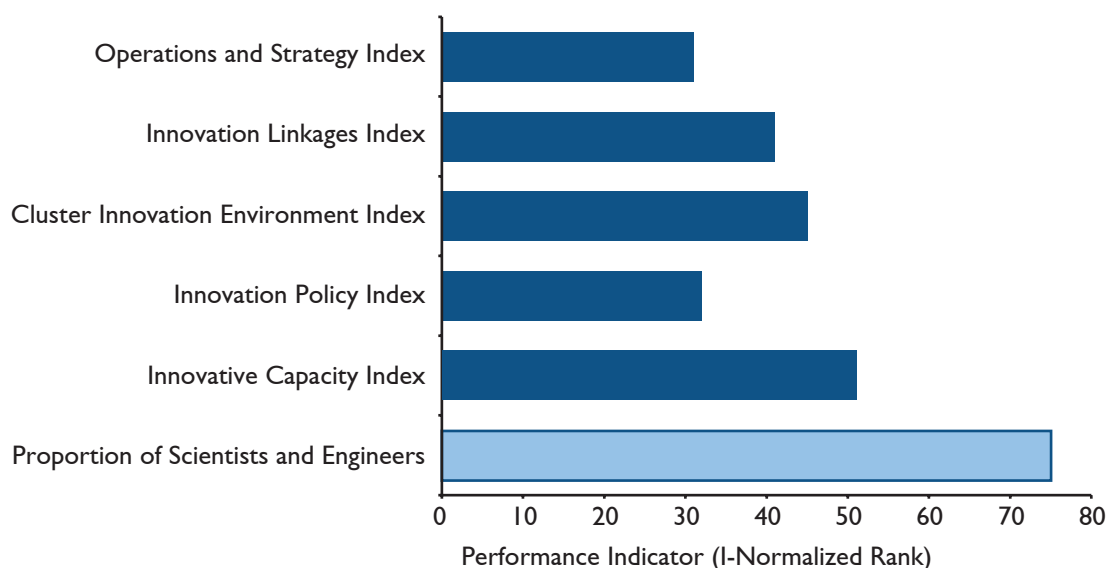
UKRAINE'S NATIONAL INNOVATIVE CAPACITY

In last year's GCR, Michael Porter and Scott Stern sought to rank countries by *national innovative capacity*. The framework for their analysis links the *common innovation infrastructure* - the pool of human and financial resources devoted to scientific and technical advances, together with relevant policies - to *conditions specific to an industrial cluster* that describe awareness of the need or opportunity for innovation along with the flexibility and capacity to respond. What determines the rate of innovation is the *quality of linkages*, in other words, the

market architecture for acquiring knowledge and turning it into commercial innovation. This market architecture combines supply-push with demand-pull mechanisms.

Using answers to selected questions from the Executive Survey that forms the core of the GCR, Porter and Stern rank countries according to five principal indicators (as shown in Figure 10), where the length of the bars is proportional to performance relative to other countries

FIGURE 10: UKRAINE'S PERFORMANCE ON NATIONAL INNOVATIVE CAPACITY (2003)



Source: Based on data from Porter and Stern (2003).

In this international comparison, Ukraine ranks high in terms of the proportion of scientists and engineers in the labor force. Its weakest showing is in the innovation policy index and the operations and strategy index. In other words,

policies to promote the adoption of innovation are deficient, as are the factors that shape the strength of the demand-pull.

NEEDED RESPONSES

On the demand side, there are few incentives at the enterprise level to create strategic product plans that identify key technologies for innovative products or assist enterprises in initiating the linkages with the science and technology base to develop those technologies. Only when market-driven enterprises begin to initiate linkages with the science and technology base as part of their strategic product planning will effective technology commercialization take place. Incentives are required to start this process.

At the same time, the private sector needs to step forward to play its role in technology development. Innovative economies are characterized by key market linkages

between institutions carrying out basic research and market-driven applied research and the development efforts of private enterprises. These linkages enable innovation through market demand-pull mechanisms to complement (and largely replace) the current reliance on the legacy of supply-push mechanisms.

Finally, any step to encourage FDI through an overhaul of the country's investment climate would provide a major boost to the country's innovative capacity. Increased FDI would help build the needed interactions and linkages with the common innovation infrastructure to produce results for enterprise growth through innovation.

A QUALITY INFRASTRUCTURE ILL-ADAPTED TO MODERN MARKETS

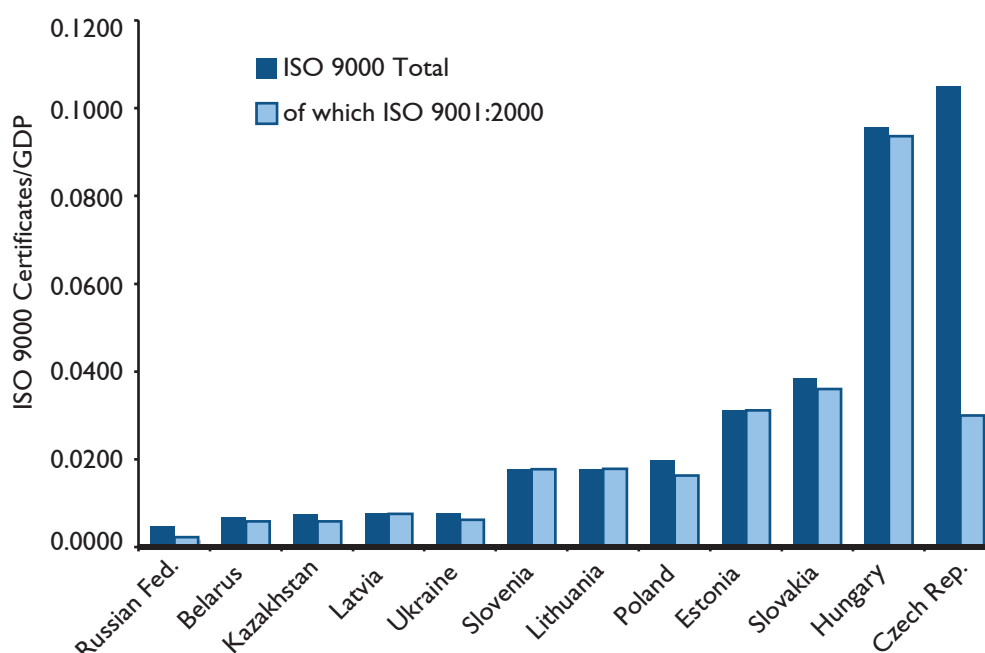
A LEGACY OF THE PAST

Deficiencies in the country's quality infrastructure - standardization, metrology, conformity assessment, accreditation, and market surveillance - put Ukraine at a disadvantage in global competition. One particular benchmark, registrations for ISO 9000 (divided by total GDP; this is the most widely known standard in the world), illustrates the magnitude of this gap (see Figure 11).

As the CIS countries began their transition to market economies, their standards system was rooted in the Soviet

GOST system. A 1992 agreement among the CIS countries on Mutual Policies in the Area of Standards, Metrology, and Certification (amended in 2000) established the Interstate Council on Standards, Metrology, and Certification, and charged it with developing a system of harmonized standards. Although signatories to the agreement honor each other's certificates of conformity and quality, their testing and certification is not recognized anywhere outside of the CIS countries.

FIGURE 11: ISO 9000 REGISTRATIONS RELATIVE TO GDP



IMPROVING THE QUALITY INFRASTRUCTURE

If Ukraine is to benefit from WTO accession by opening new markets for its industries, it needs to intensify efforts aimed at reforming its quality infrastructure in line with international best practices. It also needs to devise new programs to help industries make the transition from applying GOST standards to applying international standards or the standards for new target markets in the context of a public-private partnership. These programs should provide incentives for international consulting firms specializing in product quality and internationally recognized conformity assessment bodies to set up operations in Ukraine. Ultimately, the National Agency for Accreditation of Ukraine (NAAU) should be the only authority in Ukraine that accredits conformity assessment bodies. The State Committee on Technical Regulations and Consumer Policy of Ukraine (SCTRC) should not have any authority over external conformity assessment bodies.

In order to avoid overregulating the market and local industries, the government should at the very least reassign the authority of passing technical regulations to the Cabinet of Ministers. Better yet, a review of all relevant laws and decrees should be undertaken by the government - possibly with the assistance of an international consultant - to consolidate all legislation into one or two laws. The government should consider consolidating standardization, metrology, conformity assessment, accreditation, technical regulations, and market surveillance into one law with several chapters. This consolidation would ensure a smooth integration of all these activities into one framework under one set of principles that are compliant with WTO requirements.

MODERNIZING MARKET CHANNELS

DEFICIENCIES IN MARKET CHANNELS HARM COMPETITIVENESS

Market channels are the collections of individuals, organizations, and processes that take goods from production through to the final consumer together with the rules governing their interaction. Market channels include major points of purchase (distributors, wholesalers, and retailers) as well as transportation (trucking, shipping, railways, and air), infrastructure (roads, railways, and ports), and their related services (quality control, logistics, and freight forwarding). For a country's markets to function efficiently, market channels must operate smoothly and transparently. The performance of these channels - both domestically and in foreign trade relations - is a major factor in determining overall competitiveness.

Our assessment suggests that the competitiveness of Ukraine's companies - especially among small and medium-

sized enterprises (SMEs) - suffers from a number of challenges to its overall market channel system, including:

- a lack of adequate training for distributors;
- the high cost of capital required to engage in upgrading;
- taxes and bureaucracy involved in all aspects of domestic, import, and export trade;
- pervasive unofficial payment requirements; and
- infrastructure challenges.

The good news is that progress is indeed being made, and the sophistication of some market channels is driving an overall improvement in distribution systems across many industries.

DIRECT VS. INDIRECT DISTRIBUTION SYSTEMS

There are two kinds of distribution systems: direct and indirect. A direct system operates with no intermediaries; a producer sells directly to the consumer. Most consumer products sold in Ukraine are distributed via indirect systems whereby a product goes through one or more intermediaries before it reaches the consumer.

There are, of course, variants on the indirect distribution system: any of the intermediaries may be omitted. Recent examples of direct distribution include Amway, which reports that the main obstacle is the cost of delivering goods.

For indirect distribution systems, importing distributors serve an important role in getting foreign products into the

country. Generally, Ukrainian distributors can be critical to the success of any producer because they have the market channels covered. In a country with some 20,000 kiosks and another 50,000 small retail outlets, distributors are an integral part of the supply chain.

Smaller wholesalers of food items buy directly from producers and sell to open-air market vendors. With the arrival of Metro Cash & Carry in Kyiv in August 2003, the large-scale wholesale operation officially got underway. As its operations expand, they will have an impact not only in the market for durable goods, but in the market for fast-moving consumer goods as well.

TRANSPORTATION AND LOGISTICS

Ukraine has a functioning transportation system for the delivery of goods to points of purchase, but there is room for improvement. Though the railways were once used for a wide variety of transportation tasks, high rail transport tariffs are forcing distributors to turn to trucking companies for

transportation. At the same time, demand for trucking services exceeds supply, which leads to higher prices, delays in delivery, and problems with finding good trucking companies. Moreover, transport infrastructure also needs upgrading.

MARKET CHANNEL DEFICIENCIES

The main market channel deficiencies in Ukraine include a shortage of trucking companies, lack of training for distributors, poor roads, and corruption. The latter two are targets for macro policies. The shortage of trucking services is linked to a large extent to deficiencies in the financial system, a major weakness identified in the GCR Executive Survey and the EIU rankings.

Local and regional distributors also need training to ensure that they are performing up to the standards of their producers, or they will likely get pushed out of the market. Such concerns from producers and retailers span all industries: from beverages to construction materials, from food to electronics. Specifically designed training programs need to be conducted in partnership with major producers

and distributors to ensure that smaller distributors understand marketing, sales, logistics, information technology, and general management principles that will

help them survive in an increasingly competitive environment.

POSSIBLE INTERVENTIONS

- Work with existing programs such as USAID's Development Credit Authority (DCA) to promote new programs and instruments to facilitate access to capital.
- Support the implementation of Ukraine's concessions laws to help improve the roads and other physical infrastructure in Ukraine.
- Design and implement specific training course curricula for distributors and managers on general management skills, marketing and sales skills, and general distribution channel issues.
- Work with specific industries to create cooperative clusters that work in a collaborative environment to improve their industries' efficiency from the inside.
- Create market linkage programs to help smaller businesses in Ukraine that want to export find partners in foreign countries who will work with them in export promotion.
- Create regional export consortia and educate people about their existence. Such organizations would help demystify the exporting process by working with entrepreneurs to help them understand their potential markets, how the Customs system works, etc.

MOBILIZING FINANCIAL RESOURCES

FINANCIAL WEAKNESSES ARE BLOCKING GROWTH

The assessment of the policy environment has highlighted shortcomings in Ukraine's financial system as an obstacle to competitive performance. Limited access to capital impedes innovation and hampers enterprise growth. Ukraine is now at a critical point in the development of its financial markets. Demands placed on the banks for long-term credit in the face of low capitalization, short-term liabilities, and the potential slowing of the economy will result in greater burdens on a system that is currently struggling to remain liquid and profitable. Banks need more support and

incentives to extend credit to SMEs and arm them with the skills and tools to manage risk and create efficiency. Non-bank financial institutions (NBFIs) require greater capacity in the form of new technology, training, institution building, and capital. Finally, businesses must also learn to approach banks and NBFIs without distrust and present themselves transparently so that these institutions can work with the businesses rather than focusing on compensating for systemic inefficiencies.

COMPONENTS OF THE FINANCIAL SYSTEM

BANKS AND CREDIT UNIONS

Banks are the dominant source of liquidity for private enterprise in Ukraine. As of July 2004, 157 licensed banks held total assets of approximately USD 22.5 billion. The banking sector is highly concentrated; the top 24 banks control 72 percent of all assets and customer credits. The remaining banks are small in size and market share. Many of these smaller institutions were created - and exist - to serve large enterprise groups or corporations for the purpose of providing treasury operations and expedient liquidity. The industry experienced a significant amount of consolidation in the late 1990s, and many industry professionals believe that more consolidation is inevitable as competition increases.

High real interest rates and burdensome collateral requirements make banks an unpopular choice for capital. BIZPRO's *National Survey* conducted in 2004 reported that of all the firms surveyed, only 22.5 percent received a bank loan in 2001-2003; 56 percent of firms needing external financing did not even apply to a bank. Bank financing for SME credits accounted for only 17 percent of funding sources for firms of this size.

There are also approximately 500 registered credit unions in Ukraine, with some 493,000 members and approximately USD 50 million in assets. They focus predominantly on lending for consumer durable goods.

LEASING COMPANIES

Leasing represents only about one percent of business financing in Ukraine, compared to 25 percent in Western Europe. Despite the low level of penetration, the market has a substantial number of companies claiming to provide leasing services. Although millions of dollars pass through leasing companies, the firms themselves are only modestly profitable, largely because banks have no special lending programs for leasing companies. In order to remain

competitive, the companies keep servicing fees low. These fees also represent an additional expense to borrowers, because they are added on top of bank interest charges.

CAPITAL MARKETS

Investment banking in Ukraine is quite thin. For companies wishing to raise funds through initial public offering (IPO) in capital markets, there are no investment banks and no mechanisms for conducting these transactions. For venture capitalists, the only available channel for exiting or divesting their portfolios is to find strategic investors willing to take over the equity from their financial investment. IPO is generally not an option.

The recent surge in corporate bond issuance indicates that companies are looking to a broader portfolio of capital sources. Banks are playing a significant role in this market as intermediaries as well as investors. The corporate bond market now comprises 63.4 percent of overall debt issuance. Small and medium-sized companies do not have access to this source of financing, as the market is primarily reserved for larger firms.

PRIVATE EQUITY

There are about 48 registered venture funds in Ukraine. These venture funds typically invest on a one-off basis, do not practice portfolio investing, and are not guided by any specific investment objectives. Foreign venture capital firms are registered outside the country and operate in Ukraine as licensed asset management firms. The funding for most of these venture firms was originally all sourced overseas, but now the sources of capital are equally foreign and domestic. There are five foreign private equity funds: SigmaBleyzer, Euroventures, Commercial Capital, Western NIS Enterprise Fund, and Rubicon Capital. Capital levels for all funds are estimated at close to USD 1 billion.

COMPETITION AND COOPERATION

Competition among banks is keen for retail and corporate customers. Banks advertise their rates and products aggressively through print and other media and branch promotional activities. Despite favorable interest rates and convenient collateral requirements, banks are still forced to proactively market their services to companies because of the overwhelming distrust and skepticism among potential customers.

Competition is also keen among banks with donor-financed credit programs targeted at SMEs. Five commercial banks plus ProCredit offer loans to micro, small, and medium-sized businesses. Interestingly, banks without donor programs recognize the need to serve this

market segment but are reluctant to move into it quickly.

The level of cooperation among banks in Ukraine is not particularly high. Partnership activities such as syndicated lending are rare. The peculiarities of the banking system in Ukraine further compound the problem. Most banks established by groups of industrial concerns must cater to - and are dependent on - the close ties between shareholders and customers. Lax lending practices and cronyism call the reliability of most banks into question, and there is an inherent conflict of interest in granting large portions of loan portfolios to associates and colleagues of the banks' owners.

UNDERLYING WEAKNESSES

Capital adequacy ratios remain dangerously low. Recent and likely future changes to banks' net interest margins will further strain average capital adequacy ratios and limit the system's ability to protect against shocks.

Risk management capacity is underdeveloped. Risk management is a major concern that calls the banks' ability to manage continued rapid expansion into question.

Exposure is growing to foreign exchange and real estate risk. The continued growth in dollar-based lending and deposits exposes banks to fluctuations in exchange rates from a credit risk perspective (rather than long positions in currency trading activities). Moreover, the high affinity for real property as the preferred investment vehicle for

excess capital, a building boom in the major metropolitan areas, and large mortgage-backed credit portfolios in the banks will mostly expose the individual large banks if real estate prices fall sharply.

The NBFIs sector remains underdeveloped. A continued lack of knowledge and capacity in all NBFIs could lead to a loss of faith in alternative sources of capital. Although the financial impact of a prominent failure in the sector is not likely to impact the system, this reputation risk is important from the standpoint of overall public confidence in financial institutions.

POSSIBLE INTERVENTIONS

- (1) Develop a program to assist private enterprises in better understanding financial management options, strategies, and processes for accessing and using capital.
- (2) Assist the Credit Union Association in redesigning and developing its financial management software for member unions as part of a credit union modernization program.
- (3) Provide risk management training and technical assistance to credit unions, banks, and other financial entities to include the introduction of automated tools into best practices.
- (4) Assist credit unions in a program of independently issuing payment cards and credit cards to their members.
- (5) Strengthen the Association of Investment Business to better support and represent its members and serve all venture capital entities in Ukraine through seminars, trainings, surveys, study tours, and linkages to outside organizations.
- (6) Establish a core group of local experts to assist venture capital companies in evaluating and investing (pre- and post-financing services) in local enterprises where the value of the investment is USD 1–2 million.
- (7) Provide enterprises interested in accessing capital with technical assistance for the processes of documentation, strategy, and preparation for presenting their company to financial intermediaries.
- (8) Develop a marketing and public relations campaign that raises awareness among industry and agricultural sectors about all financial services providers, including banks, credit unions, leasing companies, and private equity.
- (9) Seek specific opportunities for firm-level technical assistance to banks for the purposes of process improvement, cost reduction, and product development.
- (10) Support legislation that streamlines lending and relieves institutions of constraints regarding liquidation of collateral.
- (11) Support, sponsor, or conduct industry events that promote innovation and bring entrepreneurs and business owners together with sources of capital and investment.

THE INFORMATION AND COMMUNICATIONS TECHNOLOGY (ICT) CLUSTER

CLUSTER COMPOSITION

Ukraine is rapidly becoming a rising star in information and communications technology (ICT), and the country's achievements are beginning to have an impact on the general state of business in both international and domestic markets. The pool of skilled labor is large, and the sciences account for a major portion of university graduates. Labor costs are low relative to Western nations, and the country's ICT professionals are known for their ability to work on complex, multi-faceted projects covering a range of disciplines. Ukraine possesses abundant experience in research and development (R&D) that has produced innovative and creative thinkers for the workforce. All of these features are the right ingredients for a successful and thriving technology sector.

In Ukraine, there are some 1,300 officially registered companies delivering software-related products and services,

900 computer hardware providers, and 400 internet service providers (ISPs). The total turnover is estimated at USD 450 million in computer hardware sales and USD 125 million in ICT services. Industry experts estimate that more than 50,000 people are actively engaged in ICT-related activities. All of these numbers are rough estimates given the proliferation of the shadow market and unclear registration procedures.

Multinational companies now reflect a much larger percentage of the industry for commercial technology solutions, accounting for approximately 60 percent. Local registered firms make up about 30 percent of the market, and the remaining 10 percent comprises small shadow-market groups working primarily on small offshore orders for software development.

DEMAND

The Ukrainian government is by far the largest domestic market for technology and informatics, although available figures do not allow for a separate breakout of total expenditures. Among the commercial users, insiders believe

that the largest markets are manufacturing, telecommunications, financial services and banking, and logistics and procurement. Table 1 provides an overview of the likely magnitude of catch-up demand.

TABLE 1: LEVEL OF ICT PENETRATION - KEY INDICATORS

Indicator	Penetration Rate (%)
Computers installed in businesses	0.65%
Personal computers	1.8%
Internet penetration	3-7%
Business Internet penetration	4.5%

Local experts attribute the slow uptake in technology to a number of factors, including:

- a lack of capital for investments, especially in industry-specific technologies;
- few affordable solutions in the market;
- the small number of computers in businesses;
- policy gaps between government and industry on various issues, including licensing,

commercialization of technology, and the lack of a national ICT strategy;

- aging infrastructure, high cost, and poor quality of telecommunications and energy; and
- insufficient awareness of technology's benefits due to generation gaps or isolation.

Even so, the prospects for domestic demand remain strong due to anticipated growth in government technology spending, modernization of telecommunications and energy

infrastructures, and stubbornly low computerization penetration rates in the hard industrial sectors. ICT industry participants also cite a number of market trends including:

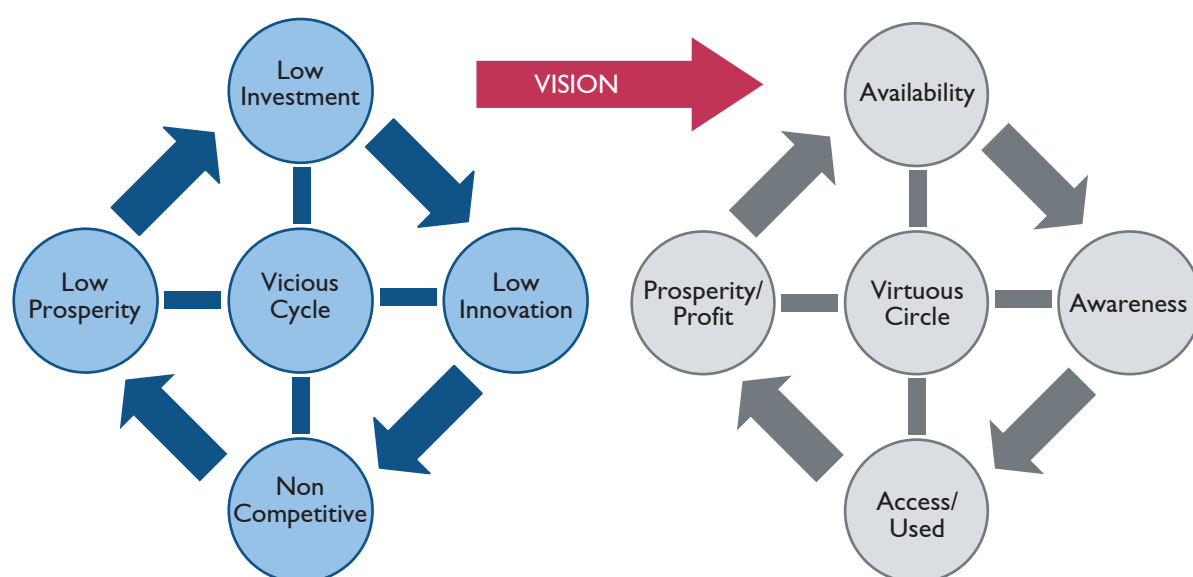
- market consolidation and integration of existing players;
- stable growth of the ICT services market;
- professional development of specialists;
- an increase in professional association activity;
- a greater need for certifications;
- companies searching for and occupying unique niches;
- an increase in domestic competition; and
- software product export growth.

PROBLEMS AND RESPONSES

The vision is to transform Ukrainian industry from a *vicious cycle* of low investment, low innovation, and low prosperity into a *virtuous circle* of increased access to - and use of -

ICT products and services through sector development activities, along with improved market access between ICT suppliers and potential customers.

FIGURE 12: THE VISION FOR THE ICT CLUSTER



An **ICT Diffusion Initiative** would address ICT availability, awareness, access, and use, resulting in a series of activities including promotional programs, exhibitions, and seminars. The Initiative should promote cooperation between relevant business associations, universities, and the government to ensure the sustainability and credibility of the initiative.

As a preliminary step, it is essential to understand the current penetration and impact of ICT in selected sectors. Any assessment to this end must identify the specific types of technology and solutions most valuable to each industry, analyze the measures of business performance, the penetration of ICT, and the impact of ICT penetration in non-ICT companies. An assessment would help determine which technologies are important or have a heavy influence on business performance as well as assist in identifying and quantifying ICT needs and opportunities in the sectors studied.

On the availability side of the equation, the study should assess available products and services of local ICT companies that would fill sector technology needs. The project must work with industry associations and the ICT sector to increase awareness of business opportunities and identify gaps in technology that can be filled by ICT companies. In some cases, there is already an awareness of ICT solutions but no companies that are providing availability and access to those solutions. More likely, there are innovations available through Ukrainian ICT companies, but other industry players are unaware of them.

Solutions to this availability/awareness gap could include association literature specifically tailored to the ICT needs of industry sectors, joint university and corporate research efforts focused on specific industries, and advertising and public service campaigns highlighting the competitive benefits of ICT.

THE TEXTILES AND APPAREL CLUSTER

THE STATUS OF THE CLUSTER

Prior to 1991, the Ukrainian textile and apparel sector supplied up to 50 percent of the textile and apparel requirements of the Soviet Union. Since then, the sector has undergone dramatic changes and adjusted to prevailing market conditions. Today, there are roughly 6,000 companies, 4,700 of which qualify as small enterprises.

Ukraine is a net exporter of textiles and apparel. In 2003, apparel imports increased by more than 42 percent over the previous year to more than USD 410 million (see Figure 14). Imports of textiles also increased dramatically to over USD 510 million. In the case of knitted fabrics, imports increased by 77 percent. Imports of fabrics relate in part to garments that are made up under tolling schemes and then re-exported.

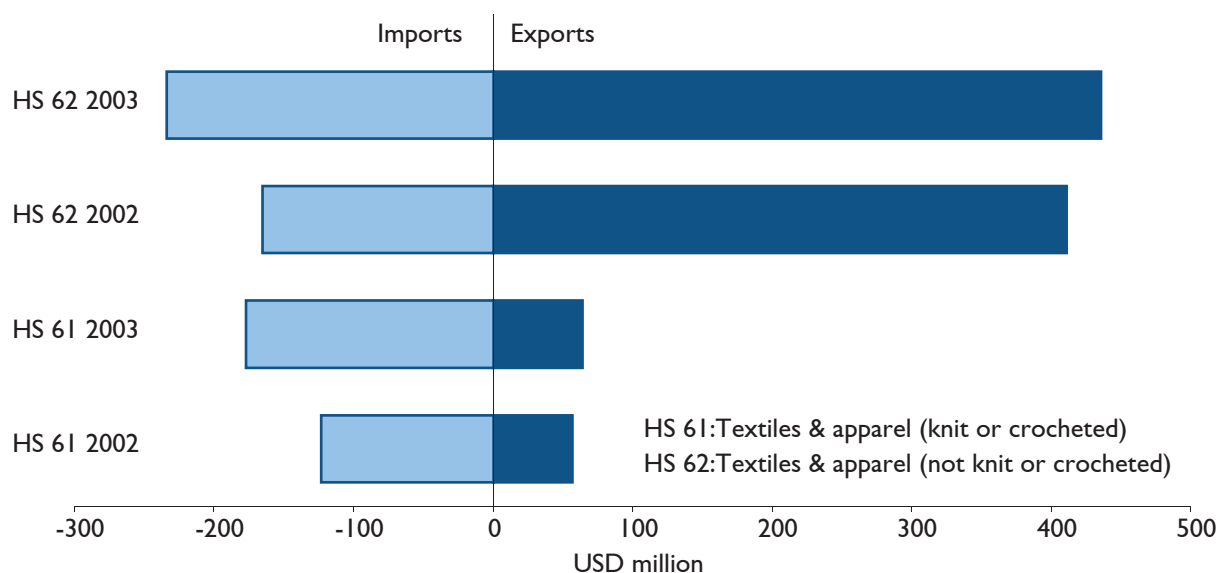
Exports show a 6 percent increase for garments made up of woven fabrics (by far the larger export), and a 12.5 percent increase for knitted garments. Total exports of garments amounted to over USD 498 million, while exports of fabrics only amounted to USD 62 million. Most of the export

market is made up of garments manufactured under tolling schemes, with little “own label” penetration. The domestic market for apparel is estimated at USD 1.8 billion, and is estimated to grow by around USD 400 million annually. Growth is being driven by rising personal incomes in Ukraine. It is expected that imported fabrics and garments (particularly from Asia) will supply much of this demand.

The bulk of Ukraine’s apparel export trade (almost USD 430 million) consists of fashion items where proximity to the market, flexibility, and quality are determining factors. There has been a substantial influx of new investment in the sector from EU companies looking to relocate their production to a lower-cost proximate industry. It is likely, therefore, that the recent scrapping of textile and apparel quotas will have a limited impact on activity in this cluster. As Figure 15 shows, about three-quarters of total exports go to the EU.

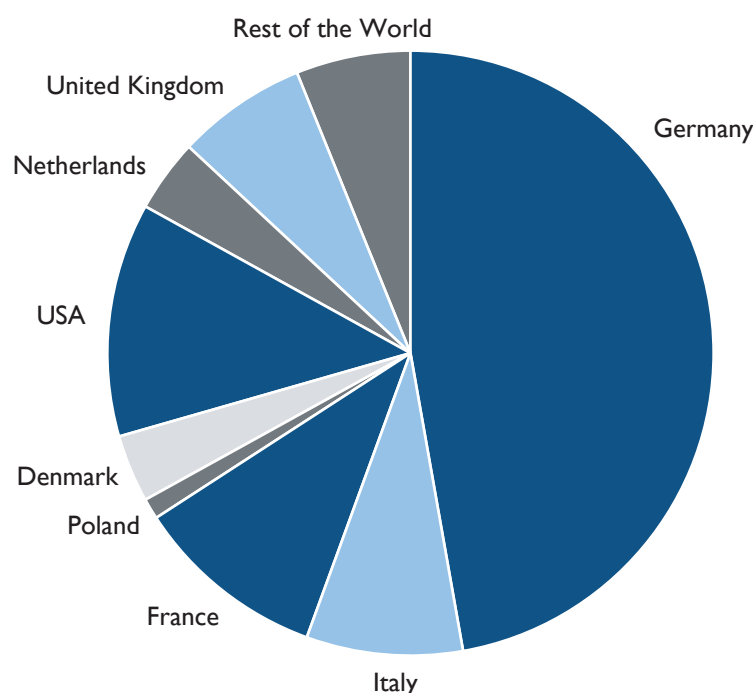
In March 2005, BIZPRO will publish the *Textiles and Apparel Sector Diagnostic* report which provides comprehensive analysis of the sector.

FIGURE 13: IMPORT AND EXPORTS OF TEXTILES AND APPAREL (2002-2003)



Source: GTA.

FIGURE 14: EXPORTS OF TEXTILES AND APPAREL BY COUNTRY OF DESTINATION, 2003



Source: GTA.

PROBLEMS AND RESPONSES

While the textile and apparel industry is settled and progressing under its own steam, it does face certain constraints that hinder expansion and keep it from gaining market shares. Certain components of the sector (most notably, the fabric production and trim industries) must be strengthened, which would enhance the performance of the sector as a whole. Some of the problems faced by the textiles and apparel sector are:

- *Access to appropriate finance* in order to recapitalize.
- *Availability of qualified operators.* The growth of the sector has resulted in a shortage of qualified operators, which has in turn resulted in upward pressure on salary levels. Given that each factory or production manager has his or her own approach to training, the training of operators is best left to the industry itself. There may be scope, however, to provide specialized production training to graduates of light industry technical schools.
- *Understanding of export market requirements.* This issue relates more specifically to those enterprises that wish to supply “own label” garments. There is limited understanding of the fact that each export market has distinct preferences in terms of colorways, designs, and associated fabric and trim use, and that each export market has different nuances.
- *Awareness of market conditions.* Companies operating in terms of tolling schemes are generally unaware of other buyers who may offer better prices and conditions. They are so busy getting throughput that they miss the opportunity to explore other linkages. But it is important that the enterprises have fallback positions. The industry

is notoriously fickle, and buyers often change suppliers on a whim. It is important that the enterprises have fallback positions.

- *Problems with VAT reimbursements on inputs.* Onerous VAT reclaim procedures prevent many enterprises from extending their range of services. Local sourcing of trims, fabrics, and packaging is effectively excluded as an option, because VAT adds close to 20 percent to the product price and consumes management time in the reclaim process. The cumbersome VAT reimbursement procedure makes it easier to rely on tolling operations with all of the inputs provided rather than develop backward linkages to local producers.
- *Poor quality of fabrics and trim.* For the most part, the fabric and trim industries do not offer items of requisite quality. These industries could grow through joint ventures with foreign partners who may be able to provide capital and technical assistance to upgrade their facilities and bring these industries in line with current market requirements.
- *Rudimentary production facilities for flax and linen.* The flax and linen industry has great potential in a world that is moving toward the use of natural fibers for household items. The industry is in need of recapitalization and design pointers in order to grasp the opportunities of this trend.

Specific initiatives to help the industry grow and compete more successfully should be focused on companies that have the capacity, inclination, and motivation to improve. As there is no association that effectively represents the sector,

interventions need to work with geographic groupings of enterprises in order to maximize the use of technical assistance. Some initiatives that would have the potential to improve the competitiveness of the sector are:

- *Assistance to enterprises to improve approaches to marketing* with emphasis on targeted communication and promotion skills, market linkages and brand development.
- *Identification of buyers and linkages to enterprises.* Inputs would include identification of buyers in the main markets proximate to Ukraine and developing a linkage program to introduce the role players.
- *Convening market preference workshops.* Inputs would include assistance from recognized market experts in explaining specific market trends, nuances, and expectations. Local designers would learn about market preferences and network with manufacturers.

THE FURNITURE CLUSTER

THE STATUS OF THE CLUSTER

The furniture industry in Ukraine is growing, with production expected to increase by 26 to 30 percent in 2004. Sales are projected by some to hit USD 700-800 million thanks to rising investment, quality improvements, and domestic and export market growth. Government officials predict that by 2006, furniture production will top that of 1991 - the industry's best year before the collapse of the Soviet Union. In 2003, the Ukrainian furniture industry attracted nearly USD 100 million in foreign direct investment.

There may be as many as 9,000 registered furniture-making "companies" and woodworking shops in Ukraine, most of which are individual entrepreneurs or very small firms that simply assemble furniture in their own workshops. Official government statistics list 1,745 registered furniture companies in 2003. Most experts agree that there are about 700 actual furniture factories in Ukraine, though many are very small and only 30 companies or so can be classified as major furniture producers. The All-Ukrainian League of Furniture Manufacturers estimates that 11 of the 30 companies produce more than 50 percent of Ukraine's total furniture output, and 21 companies are responsible for more than 70 percent of output.

Large furniture companies (those with an output of at least USD 200,000 per month) represent 3.5 percent of the total number of firms, while those with an output of USD 25,000-30,000 represent 60 to 65 percent of the companies in the sector. Approximately 25 to 30 percent of domestically produced furniture is made by small producers called *garazhniki* which manufacture furniture by copying trademarked models and selling them at a discount of 20 to 25 percent compared to specialized manufacturers, often in open-air markets. The largest furniture manufacturers claim they are increasing market share and pushing the smallest companies out of the market because they can better compete on quality, price, and promotion. These trends

are significantly reducing the sector's workforce: for 2001, estimates put job losses in the furniture industry at 12.5 percent. According to experts, the only small companies that will survive over the medium to long term will be those offering custom-made furniture.

There are approximately 530 "medium or large" firms, employing 50 or more workers. These major manufacturers produce more than 70 percent of domestic output. For now, the largest furniture manufacturer in Ukraine is Merx-Mebli, which has four manufacturing plants and 35 retail stores throughout the country. The second largest domestic manufacturer is Novy Style, an office furniture producer in Kharkiv which is a Polish-Ukrainian joint venture; the firm claims to no longer have any competition, having "won the war." Other major players include: Enran, Irma/Amati, Intekhservis/Snait, Narbutas, Liga Nova, Neopol, KMK (Kyiv Furniture Factory), Art-Metal Furniture Holding, and Progress.

There is plenty of capacity in the industry, especially in categories where Ukraine is already having some success with exports such as office chairs and wooden furniture. One furniture association estimates that the industry is only operating at about 40 percent capacity. Ukraine is already one of the top 20 exporters of office chairs, and there is a ready market in the CIS countries for wooden furniture - especially in Russia, which currently sources more of such imports from Italy than anywhere else. Strong Ukrainian companies are being considered by U.S. companies as potential exporters, and the quality of their furniture meets international standards. A number of companies in Ukraine are already ISO 9000 certified, and many others are banding together in associations and clusters to increase their overall market power.

In March 2005, BIZPRO will publish the *Furniture Sector Diagnostic* report which provides comprehensive analysis of the sector.

THE COMPETITIVE SITUATION

A brief "five forces" analysis looks at the competitiveness of an industry by assessing the competition among rivals, the power relationship between suppliers and rivals, the power relationships between buyers and rivals, the threat to rivals of potential new entrants to the market, and the threat of substitute products to rivals.

Competition among rivals: In the Ukrainian furniture industry, the main competitors are the 30 largest producers, who have more of a friendly rivalry than out-and-out war. They do experience some competition from smaller players, but in general the larger producers

are able to better compete on price, quality, and promotion. Domestic producers also face stiff competition from Italian imports and black- and gray-market producers.

Power relations between manufacturers and suppliers: Suppliers have much of the power over manufacturers that are not vertically integrated. They set prices that smaller manufacturers must live with. These manufacturers have some choices but are limited by the lack of a large pool of suppliers from which to draw.

Power relations between manufacturers and buyers: In most cases, the balance of power lies with consumers. In some cases - such as office furniture - prices are high across the board, so the manufacturers have the power. But in general, consumers have many manufacturers to choose from, and they always have the option of going to black- or gray-market sellers for a 10 to 15 percent price reduction.

The threat of potential entrants/barriers to entry: Because almost anyone can set up shop in his or her own house, barriers to entry are low for small

producers. However, barriers to entry are high for those who want to become major manufacturers, because the cost of land and equipment is prohibitively high.

The threat of substitute products: The main threat of substitution comes from black- and gray-market furniture, mainly found in open-air markets. Custom-made furniture also has its own black market, where people can get furnishings for a 10 to 15 percent discount from what one would pay to a legitimate operation.

COOPERATION

Cooperation in the industry mostly involves companies banding together to lobby for changes in regulations. There are three furniture associations operating in Ukraine, including the Ukrainian Association of Furniture Manufacturers (UAFM), the All-Ukrainian League of Furniture Makers, and the Mebliderevprom Association. Founded in September 2001, UAFM has 38 members. In addition to furniture manufacturers, its membership includes supportive and related industry partners such as mass media sources, exhibition centers, and an insurance broker. Among other activities, UAFM works to develop industry infrastructure, create good conditions for exporting, create a more competitive industry, and lobby the government. It also helps its

members form partnerships, collaborate on joint projects, and participate in consolidated marketing. Members even get access to legal counsel when necessary. For the past year and a half, UAFM has been working with the government to enact antidumping legislation in an attempt to curb imports of cheap furniture from Poland and Slovakia. UAFM is committed to creating a competitive environment for the furniture industry in Ukraine; for example, it opposes import tariffs on imported furniture and would rather have these tariffs removed altogether. UAFM would prefer to compete on a level playing field with (legal) imports from Italy, China, Poland, and other countries.

DEMAND

Furniture consumption in Ukraine is very low: officially, it was only about USD 10 per capita in 2001, rising to USD 25 in 2002 before reaching USD 34 in 2003 - a significant growth in view of the country's low per capita income of approximately USD 100 per month. At this rate, Ukrainians are approaching per capita furniture expenditure levels of Eastern Europe. In 2002, annual per capita spending on furniture was USD 40 in Poland and USD 45 in Hungary. In the EU, by contrast, annual

per capita spending on furniture was EUR 259 in 2002. The low but rising per capita spending in Ukraine indicates a relatively untapped market. Currently, the main market for furniture consists of middle- and upper-class Ukrainians. In 2001, imports accounted for roughly 70 percent of the Ukrainian furniture market. In fact, Ukraine imports far more furniture than it exports. Ukraine imported USD 290 million worth of furniture in 2003, or USD 200 million more than it exported.

FURNITURE EXPORTS

Using the "stars" analysis, Figure 15 shows a graphic representation of the market performance of major furniture products exported to the European Union (EU 15). The picture that emerges from this analysis is encouraging. Total furniture imports to the EU (market size) have been growing faster than all other imports,

and Ukraine's furniture exporters have been gaining market share in all but one commodity group: parts of furniture. While there are many ways of defining competitiveness, the ability to gain market share in a growing market is a powerful indicator.

FIGURE 15: UKRAINE'S FURNITURE EXPORTS TO THE EU, 1998-2003

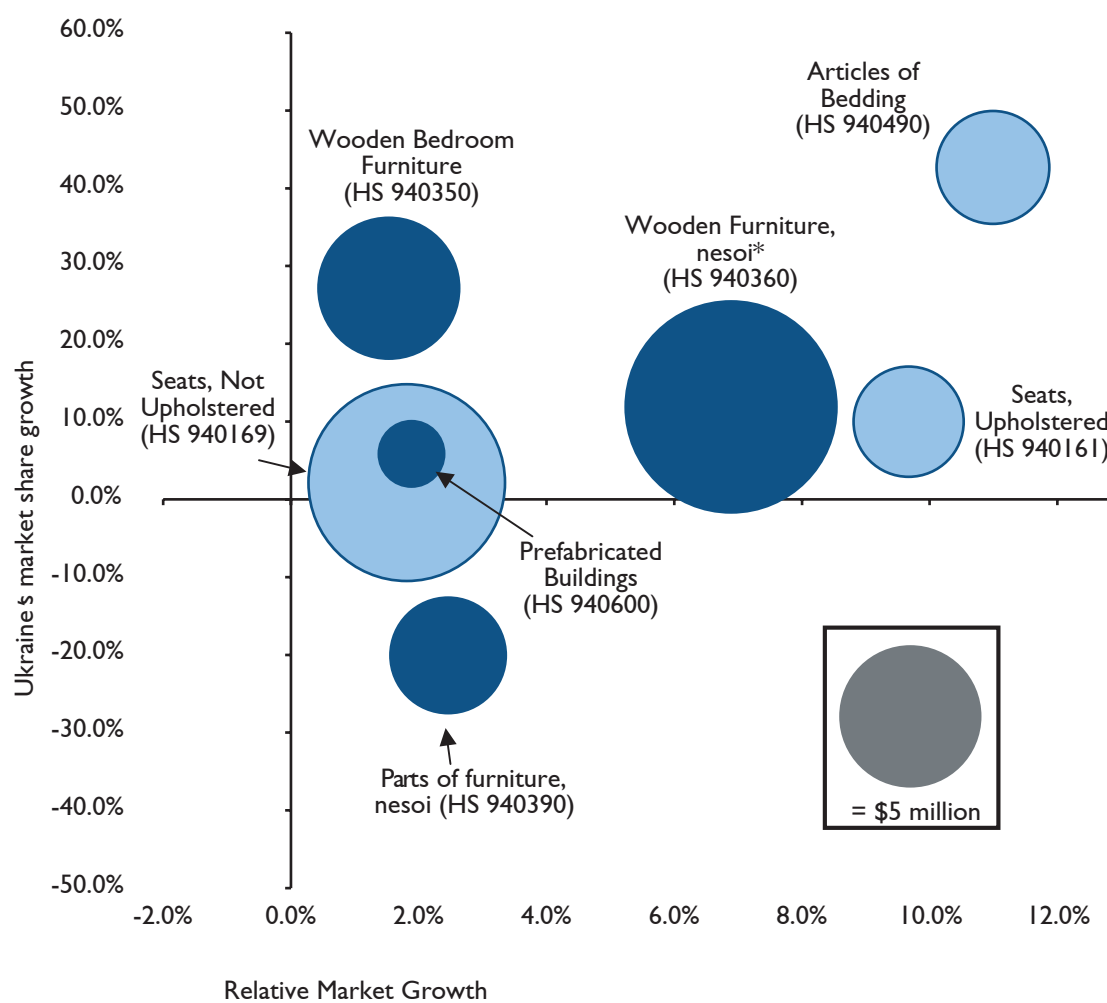
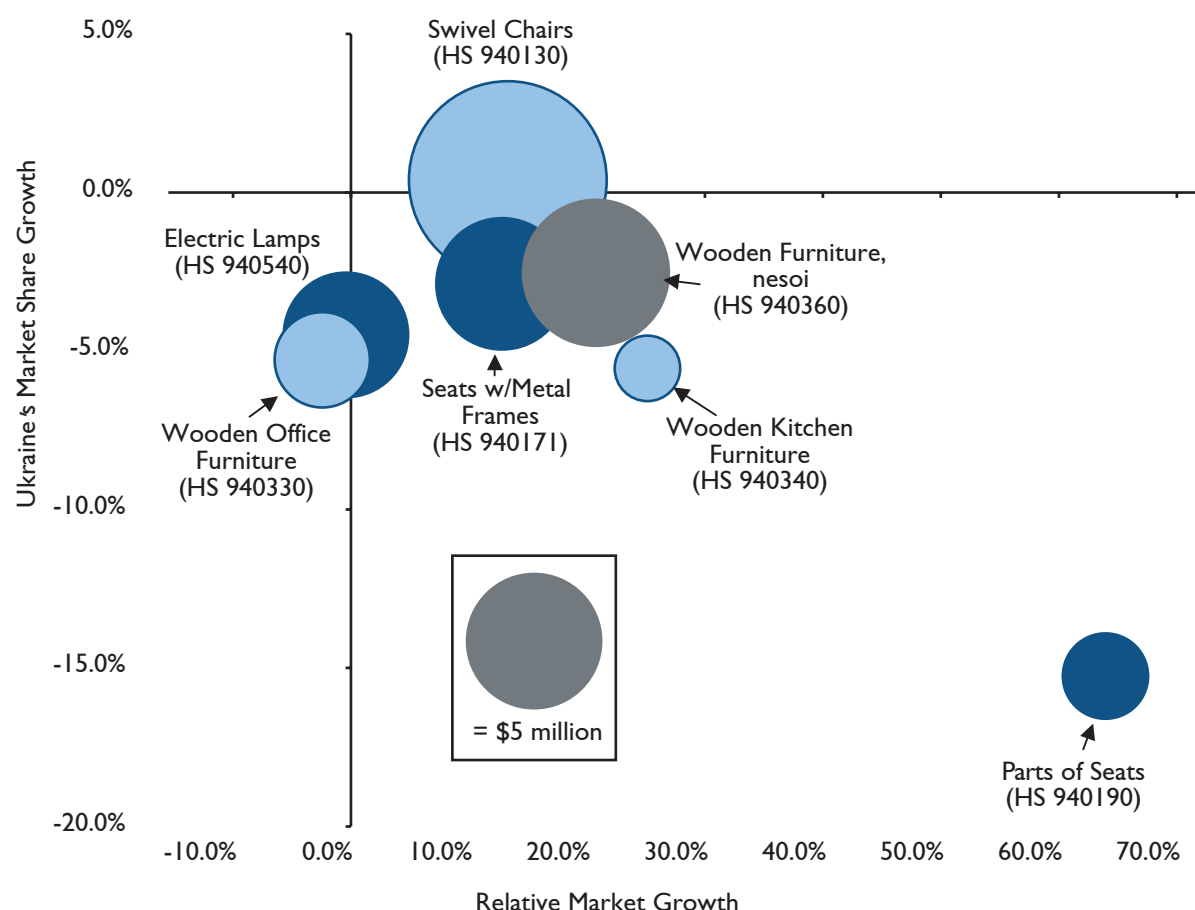


FIGURE 16: UKRAINE'S FURNITURE EXPORTS TO RUSSIA, 1999-2003

Source: GTA.

Figure 16 shows the performance of furniture exports to Russia, Ukraine's main export market. A slightly different pattern emerges from this graphic. It actually shows that Ukraine's share of the Russian furniture market is decreasing or stagnant in every category except for swivel chairs. These

patterns indicate that competition from other countries - such as Italy and Poland - is challenging Ukraine's major market, and Ukrainian furniture exporters must respond to protect and expand their market share.

FACTOR CONDITIONS: A SWOT ANALYSIS

One way to get a snapshot of the furniture industry is to look at it through the lens of a SWOT analysis (strengths, weaknesses, opportunities, and threats).

TABLE 2: SWOT ANALYSIS OF UKRAINE'S FURNITURE INDUSTRY

Strengths	Opportunities
Abundant natural resources	Lowered export prices
High quality products	Increased mass production
Cheap labor force	Expanding market demand
Strong domestic companies	Reduced export regulations
Good geographic location	Improved competitiveness against imports
Vertical integration	Expanded exports to the EU
Existence of quality standards	Creation of furniture clusters
Low barriers to entry for small producers	Improved design
Relatively easy trade environment with Russia and other CIS countries	Expanded wood furniture exports to Russia and other CIS countries

Weaknesses	Threats
Lack of marketing know-how	IKEA
Lack of skilled workers	Gray-market importers
Lack of well-trained managers	European importers
Lack of government support	Chinese importers
Difficulty importing equipment	Difficult export regulations
Lack of access to capital	IPR infringement
Poor accessory/semifinished wood suppliers	VAT returns
Uncompetitive pricing	Imported accessories/semifinished wood

PROBLEMS AND RESPONSES

ISSUE: Ukraine imports far more furniture than it exports.

ACTION: Support to industry clusters could strengthen the market power and flexibility of domestic companies. The cluster must tackle the quality reputation of Ukrainian-produced furniture to attract brand-conscious consumers, who currently buy imports because they believe domestic furniture is inferior.

ISSUE: Ukrainian furniture companies need access to capital to upgrade and expand.

ACTION: New avenues need to be explored, such as working with international financial institutions and domestic banks to provide better loan terms. Credit unions are also a possible target for cooperation because they have lower collateral requirements, but they provide smaller loans with higher interest rates. The goal would be to convince banks to offer longer-term loans with lower interest rates and lower collateral requirements to companies with established records and high export potential.

ISSUE: Ukrainian companies do not know how to market themselves and often do not have an adequate understanding of foreign markets.

ACTION: Create marketing seminars designed to help furniture manufacturers understand the basics of marketing and sales and focus on what it takes to attract foreign partners and distributors. Continue to work with foreign buyers and buyer agents to help identify foreign partners, and consider bringing them to Ukraine to meet companies ready to export or seeking to increase their exports.

ISSUE: Gray-market activity is still a major factor.

ACTION: Work with the furniture associations to lobby the government to lower import duties pending WTO accession, thereby reducing the need for importers to misclassify their goods. On the domestic front, large producers can consider reducing prices so that their products are actually cheaper than those supplied by gray-market operators.

ISSUE: Ukrainian companies need to be able to develop their own designs.

ACTION: Facilitate the creation of a furniture design bureau available to multiple companies. The bureau could be part of a furniture cluster, and could help inspire Ukrainian companies to come up with their own designs to take to trade shows and exhibitions. The bureau could be staffed by designers from universities as part of an internship program sponsored by a furniture association or cluster. The companies could then make a name for themselves as sources of innovative design rather than just sources of cheap labor and raw materials.

THE HOME FURNISHINGS CLUSTER

INTRODUCTION

The home furnishings cluster in Ukraine is clearly demarcated in terms of the market in which it competes - but diverse in terms of the various value chains in different states of development. "Home furnishings" refers to all household items used for functional and decorative purposes (other than furniture and construction materials). On the commercial level, the term typically excludes unique and expensive individualized artwork but focuses instead on items which can be profitable through mass production or - at a minimum - through bulk sales. Thus, the market for home furnishings includes a wide variety of products such as lamps, bathmats, bed linens, curtains, candles and candle

holders, ornaments, frames, and other decorative items. Any given product within these categories can be produced from a range of materials, including plastic, wood, wicker, willow, wrought iron, glass, ceramics, porcelain, metals, cotton, polyester, satin, calico, and other materials.

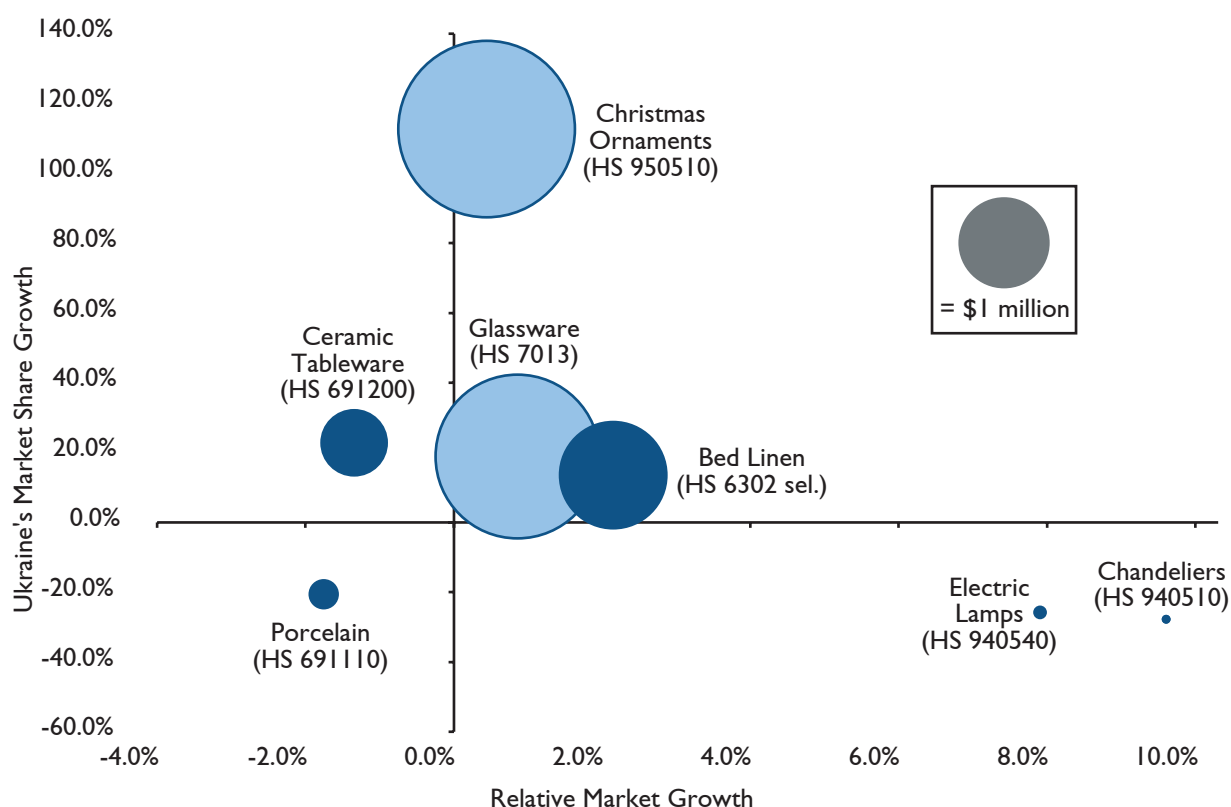
One of the reasons to examine home furnishings is that it is often one of the few industries in which a developing country can show or develop competitive advantage, usually because of factor conditions such as good raw materials, traditional skills, and low labor costs.

EXPORT PERFORMANCE AND COMPETITIVENESS PROSPECTS

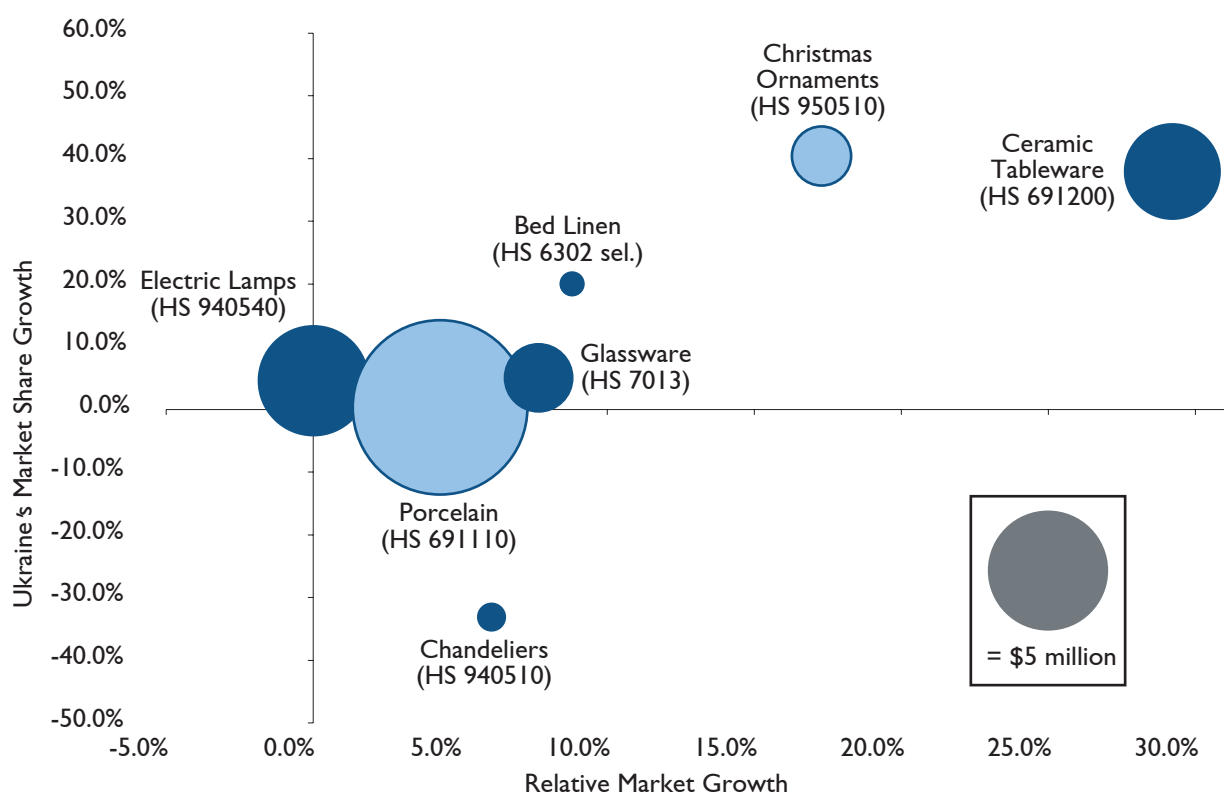
Figure 17 provides an overview of the performance of selected home furnishings in the EU market. The top three items in this category - Christmas ornaments, glassware, and bed linens - all target markets that are growing faster than total EU imports. Moreover, there is a trend for European home furnishing manufacturers in certain subsectors to shut

down European production in favor of developing countries or transition economies that offer cheaper labor. These trends may create opportunities for Ukraine, especially in competitive commodities where time and cost to market might be an advantage (such as fashion-driven industries like table linens).

FIGURE 17: EXPORT MARKET PERFORMANCE OF SELECTED HOME FURNISHINGS IN THE EU



Source: GTA.

FIGURE 18: EXPORT MARKET PERFORMANCE OF SELECTED HOME FURNISHINGS IN RUSSIA

Source: GTA. Note that the bubbles use a different scale and are therefore not directly comparable to the ones in Figure 17.

Figure 18 shows a variety of home furnishings subsectors and their position relative to growth in Russian markets and growth in Ukraine's market share. For Christmas ornaments, ceramic tableware, glassware, bed linens, and - to a smaller

extent - electric lamps, the market share held by Ukraine's exports is expanding in a growing Russian market. The Ukrainian market share of porcelain remains stable in a growing Russian market.

TARGETS FOR COMPETITIVENESS INTERVENTIONS

This analysis suggests the following commodities and their respective value chains as targets for enterprise growth interventions:

GLASSWARE

Ukrainian exports of glass products grew by 26.5 percent between 2002 and 2003, mostly to Russia, the Netherlands, and Germany. The domestic market also creates opportunities: in 2003, Ukraine imported four times more in glassware than it exported (USD 20.2 million versus USD 5.5 million). The competitive strengths are based on skilled workers, low labor costs, and a long tradition of glassmaking. But the cluster is in need of improved designs and production techniques that would better assure a significant sustainable penetration of offshore markets.

WROUGHT IRON

Ukrainian competitiveness in this sector is most likely to be achieved in niche artistic export work or in mass production. The domestic market for wrought iron is reportedly growing as the purchasing power of the average Ukrainian grows. In terms of exports, overall exports between 2001 and 2002 dropped slightly due to a decrease in demand from Russia. The main external competition for

the wrought iron industry as a whole comes from Poland and China, which cheaply mass produce low-end iron.

CHRISTMAS ORNAMENTS

Ukraine's competitive strength in this commodity rests on a long tradition. There are currently 15 companies active in this sector. It is estimated that the domestic market for Christmas ornaments is about USD 2 million. Overall, the export market grew between 2002 and 2003 by 55 percent to USD 5.3 million, with Germany and Russia as the main customers.

PORCELAIN

Ukraine has ample deposits of high quality kaolin (white clay). Most exports of finished products (USD 11.2 million in 2003) go to Russia as a continuation of traditional market relationships. The technologies used in porcelain production are old and power-intensive. Upgrading to newer production processes would reduce power consumption (now accounting for 40-60 percent of the cost of production) by a factor of six.

CERAMICS

Total exports in 2003 amounted to USD 4.7 million, with over 70 percent going to Russia. The old technologies in use do not allow producers to follow the requirements of

foreign customers. There are indications that exports to the Czech Republic and Slovakia (traditional suppliers of kitchenware), have picked up recently, although still at a low level.

PROBLEMS AND RESPONSES

ISSUE: Inability to accurately forecast the cost of inputs for production and set stable prices.

ACTION: Either an open or a cluster-specific training program for interested companies would focus on financial models for forecasting costs, developing prices for their goods, and evaluating and managing risk. Companies can learn from each other and from more formal financial training.

ISSUE: Lack of cooperation or collaboration between firms.

ACTION: Support cluster initiatives that bring together producers and all of the major players in the value chain, from raw materials suppliers to retailers in the target commodities: glass, ceramics, wrought iron, and porcelain. Such cluster initiatives would create a dynamic environment for growth, problem solving, and export promotion.

ISSUE: Poor access to export markets

ACTION: Work with overseas buyers and agents in promising subsectors (identified in market assessments) to identify demand in foreign markets and build the capacity of competitive Ukrainian companies - including training to export their products. It could also co-fund participation of Ukrainian companies in international trade shows. Specific export training sessions could be offered, covering issues such as when, where, and how to export; how to market to overseas partners; and how to get references from clients about issues that will matter to overseas partners, including: quotes about timeliness, problem solving, and quality, accompanied by contact information including phone and email.

ISSUE: Inadequate sales and marketing knowledge and skills.

ACTION: Conduct marketing training sessions with a focus on market analysis (both domestic and international). One of the topics is an introduction to possible systems for distribution (commission-based, intermediaries, wholesale traders, etc.), and branding. Bring buyers over to meet with successful factories and provide training to promising companies.

ISSUE: Lack of independent Ukrainian agents specializing in home furnishings.

ACTION: Identify, train, and empower domestic agents who will serve as international brokers for competitive clusters and their products in overseas markets. Such agents may need to be brought in from other countries.

ISSUE: Inadequate access to capital.

ACTION: Work with interested banks, credit unions, and international funding agencies to establish better credit terms. There are some EBRD lines of credit available through banks for as low as 16 percent.

THE LEATHER AND FOOTWEAR CLUSTER

STATUS OF THE CLUSTER

The leather and footwear industry has shrunk severely from the time when Ukraine supplied up to one-third of all footwear for the USSR. The sector is, however, beginning to regain impetus and is expected to grow further with new investment in the industry. The National Union of Leather and Footwear Manufacturers, UkrKozhObuv, estimates that there are in excess of 3,500 footwear producers in Ukraine. The companies vary in size, from five employees to more than 500. The industry produces an estimated 35 million pairs of shoes a year, with a further 3 to 4 million produced under tolling schemes for foreign clients. The bulk of local production is sold locally.

Most exports from this sector are destined for EU member countries, though there is significant growth in the export of wet blue hides to China and Hong Kong. Total exports from

the sector account for more than USD 200 million, around 1.5 percent of total Ukrainian exports. Total imports in the sector amount to more than USD 400 million, the bulk of which is footwear. Import statistics in the sector are less reliable, as there is a substantial gray market in footwear where shoes are either undervalued or not declared for Customs purposes.

Ukraine is well positioned to take advantage of the flight of production from the EU. It is near one of the largest markets in the world, has a reasonably good export infrastructure, has the necessary skills and production capabilities, and offers competitive wage rates relative to productivity. A number of European buyers have already seized these opportunities and commissioned footwear manufacturing in Ukraine under tolling schemes.

LACK OF BACKWARD INTEGRATION

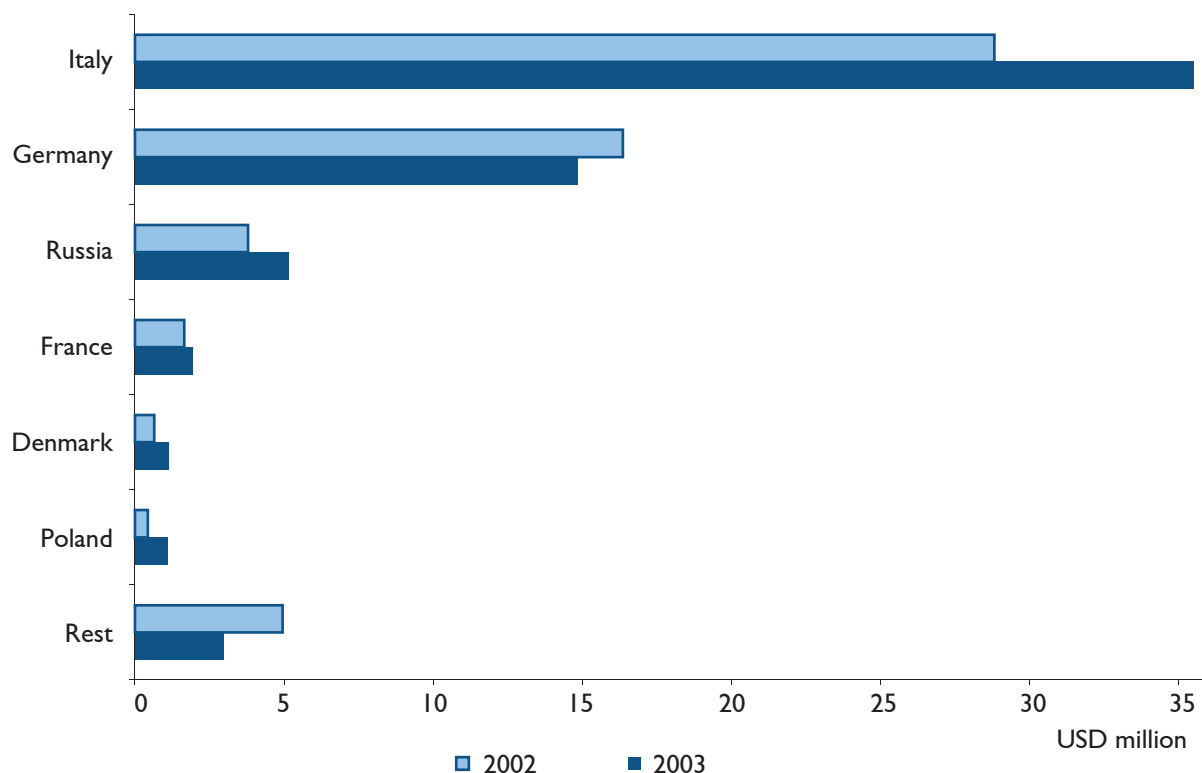
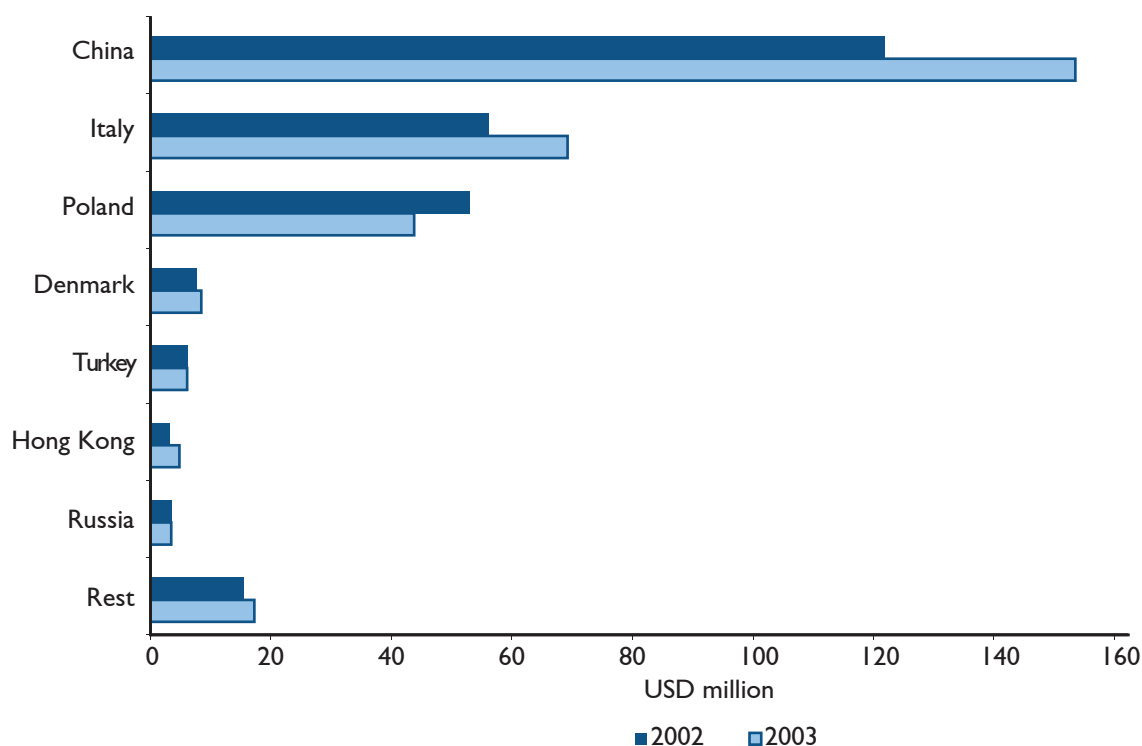
A current shortage of local hides and skins means that some tanners import up to 80 percent of their input (mostly from Italy and Austria). Imports of raw hides and skins amount to more than USD 20 million annually. The shortage stems from a reduction in herd numbers as a result of climatic and economic conditions. Furthermore, the quality of local hides has declined, as farmers are less likely to vaccinate their herds because of the associated cost. Tanners used to

expect between 25 and 35 percent of received hides to be graded 1 or 2. That figure has now declined to 5 to 7 percent. Even with the reduction in the number of quality hides and an increase of up to 30 percent in the price of raw hides, the tanners maintain that the industry remains viable. The government has imposed a ban on the export of raw hides, but there is some evidence that hides are exported to Europe through Moldova.

DEMAND CONDITIONS

The tanneries are currently exporting up to 60 percent of their production in wet blue form. The balance is being finished and either exported or taken up locally. Most exports are destined for Italy, though there is a growing trend for exports to China and Hong Kong. At the current price and quality points, this trend is expected to continue. Total leather (hides, skins, and leather) exports for 2003 amounted to more than USD 130 million, an increase of 17 percent from 2002. The tanneries are looking to increase their volume of finished leather, but investment in new technology is needed to compete globally. Domestic demand for finished leather has remained static.

Exports in the footwear sector, illustrated in Figure 19, are limited to *ad hoc* sales to third parties, though companies express interest in developing export markets. The main constraint faced by the footwear producers (after access to finance) is a structured approach to developing an export market. This approach would include identifying buyers, determining product lines most suited to that market, creating an ability to alter designs or manufacture suggested designs, and introducing a proper costing and pricing structure. Companies working under tolling schemes appear to be successful, and it is expected that this sector will grow as EU members relocate their production (from Poland in particular).

FIGURE 19: EXPORTS OF FOOTWEAR BY DESTINATION COUNTRY (HS 64)**FIGURE 20: IMPORTS OF FOOTWEAR BY COUNTRY OF ORIGIN (HS 64)**

Imports from Italy, Poland, Germany, and Denmark reflect not only completed footwear, but also - to a large extent -

the components for manufacturing shoes for re-export.

PROBLEMS AND RESPONSES

The main problems faced by the leather and footwear industry are:

- Inadequate access to appropriate finance in order to recapitalize.
- Inadequate access to and understanding of export market requirements: footwear manufacturers have not had the opportunity to fully explore the specific market requirements, trends, and nuances for their targeted markets. They also have not fully explored the various buyers in the markets, or market buying preferences.
- Insufficiently contemporary design in certain instances.
- Problems with VAT reimbursements on inputs: cumbersome and ineffective VAT reclaim procedures prevent many manufacturers from competing on price points, as the VAT process effectively adds close to 20 percent onto the price of the product. The VAT reimbursement process also discourages manufacturers who are operating on tolling schemes from sourcing local inputs, which would raise the local content and value of the footwear.

Initiatives to assist the industry in growing and competing more successfully should be focused on companies that have

the capacity, inclination, and motivation to improve. A useful point of leverage is the National Union of Leather and Footwear Manufacturers. While the Union will need to be strengthened if it is to assist the industry more effectively, it can play an important role in identifying relevant companies and acting as a clearinghouse for industry-related information. Once these roles have been established, the Union could act as a facilitator for further initiatives that may include:

- group marketing of Ukrainian footwear manufacturers at trade shows;
- establishing a “Made in Ukraine” mark that would indicate quality and generate consumer loyalty;
- coordinating inward buying trips for EU buyers;
- facilitating workshops on market preferences, styles, designs, and buying procedures; and
- acting as an information center for potential investors and buyers.

These efforts would complement initiatives that are already underway to address finance and VAT issues.

THE CONSTRUCTION MATERIALS CLUSTER

TRENDS IN THE CONSTRUCTION SECTOR

Ukraine's recent growth spurt has spurred demand for new construction - and thus for construction materials. Figure 21 provides an overview of current trends in the construction sector: the value of contract work performed by construction companies, the number of construction

enterprises, and the average monthly wage, with the 1999 figures (2000 for the number of enterprises) set to 100. Construction activity (in current dollars) increased by 20 percent in 2000 and 2001 before leveling off for 2002.

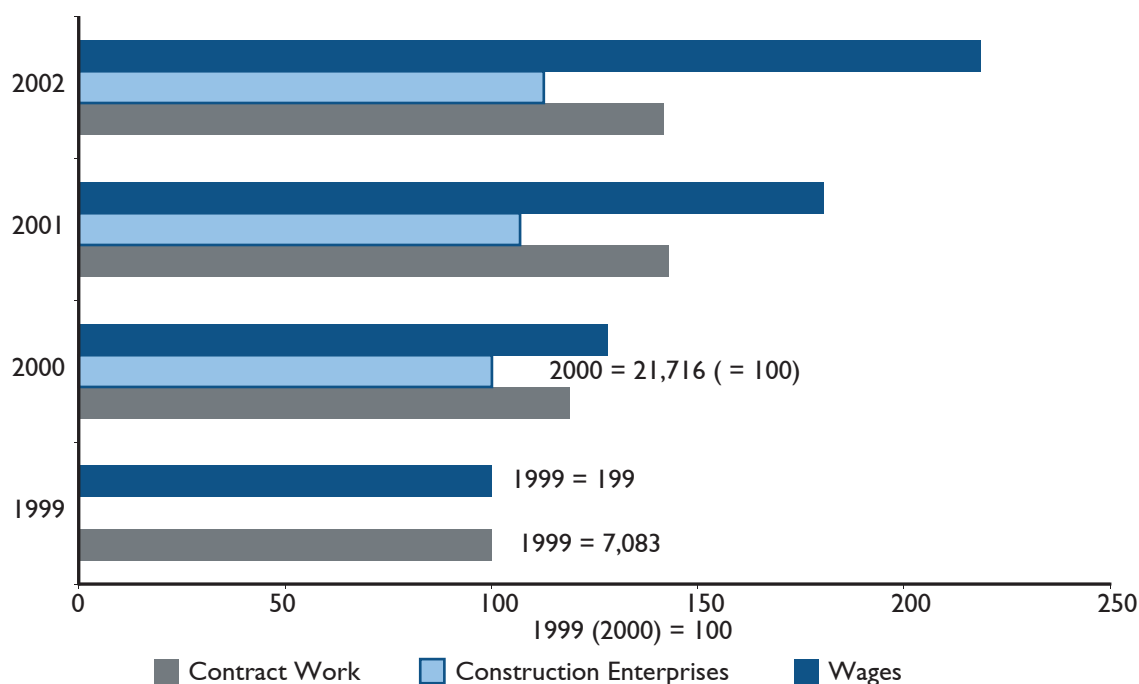
PROBLEMS AND RESPONSES

The potential for growth in the construction materials manufacturing industry in Ukraine is outstanding. Assets include: large amounts of raw materials, underutilized manufacturing capacity, a relatively skilled and educated workforce, a tolerable and improving macroeconomic environment, and a rising overall gross national product that is creating a need for a larger and improved built environment. Despite this potential, obstacles to competitiveness remain:

- Many of Ukraine's manufacturing facilities are aged and in dire need of maintenance, upgrading, and retooling.

- Quality assurance and quality control problems persist in the sector and have cast a pall over the reputation of Ukrainian-produced materials that will take a consistent, long-term effort to overcome.
- Market distribution channels for most products are poorly defined, and Ukraine's deteriorated transportation infrastructure compounds the problem.
- Marketing and brand recognition of construction products made by Ukrainian manufacturers is weak.
- Competition from imported products and materials is stiff and may be increasing.

FIGURE 21: CONSTRUCTION INDUSTRY TRENDS



Source: The State Statistics Committee of Ukraine.

ISSUES AND RESPONSES

ISSUE: Investment is required to upgrade technology.

RESPONSE: Work with finance organizations to create a program of loan guarantees or other financial instruments that will help address the issue of insurmountable collateral requirements for those seeking loans to upgrade manufacturing plants and equipment.

ISSUE: Product quality is no longer competitive.

RESPONSE: Help trade associations and related elements of the quality assurance infrastructure to form technical advisory committees charged with updating Ukrainian manufacturing standards to align them with international standards and technical regulations. It is through these volunteer technical committees - not individual manufacturers - that standards should be adopted.

Study the construction materials specifications methodology currently in use and work with architects and engineers to create a written standard for materials specifications that can be used on all construction projects. Support efforts to assist manufacturers in importing or licensing existing manufacturing technology without losing controlling interest in their enterprises.

ISSUE: Distribution channel deficiencies add cost.

RESPONSE: Through workshops, show manufacturers how independent manufacturers' representatives can sell their products at the design and contractor levels to ship directly to project sites, thereby minimizing overhead and distribution costs. Train the sales force in how to sell to architects and engineers.

ISSUE: Low level of domestic brand recognition.

RESPONSE: Creating brand recognition is much the same for construction products and materials as for other consumer products - a vigorous advertising effort can increase name familiarity among purchasers. The specifiers and purchasers of construction products are a relatively small and informed audience that requires specialized targeted marketing efforts. Training seminars can target outreach efforts.

ISSUE: Low level of cluster cooperation.

RESPONSE: Identify stakeholders specific to a particular cluster in this industry, and create vehicles such as seminars and workshops designed to inform them and bring them together. Addressing specific technical subject areas and utilizing experts from these vertical segments of the industry will promote participation.

Conduct "summit" forums between manufacturers, distributors, wholesalers, and retailers of construction materials and products. These workshops will help to educate all concerned about the problems and challenges of construction materials market channels. Invite product distribution experts with experience in these markets to moderate these meetings.

THE HORTICULTURE CLUSTER

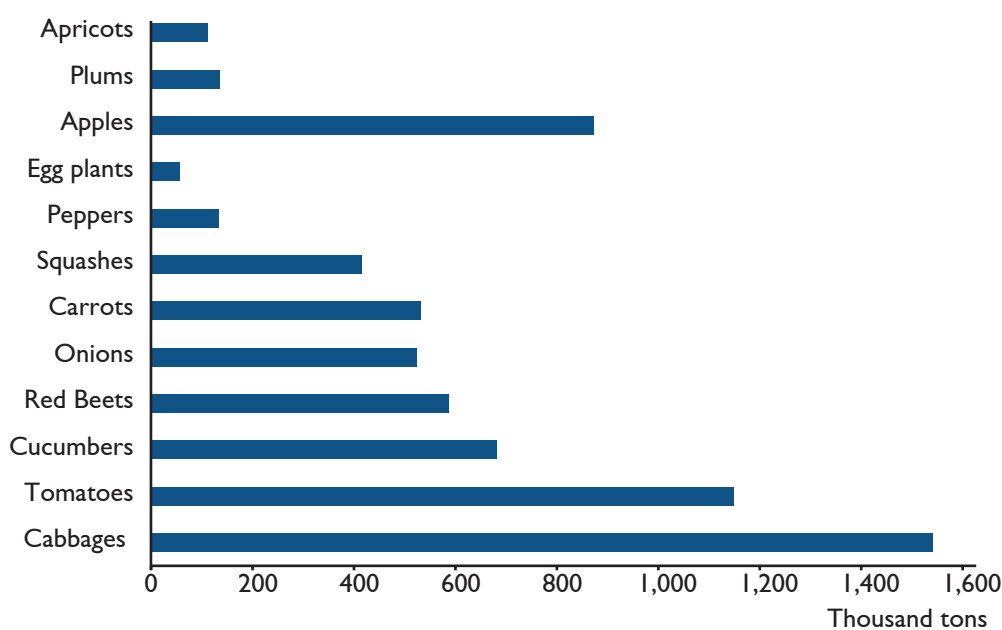
CLUSTER STATUS

Ukraine has a long and rich history of agricultural production. More than 32 million hectares - or 54 percent of the country's surface - are arable. Agriculture accounts for almost 11 percent of Ukraine's GDP, and about 32 percent of the country's population lives in rural areas. During Soviet times, planning and resource allocation emphasized the production of grain, sunflower seeds, sugar beets, and meat and dairy rather than the fruit and vegetable sector. As a result (partially because of inadequate production, and partially because of a bad distribution system), horticultural products were often in short supply, forcing people to grow their own in private land plots and "dachas." Even now, the share of home production of fresh and processed horticultural products remains high.

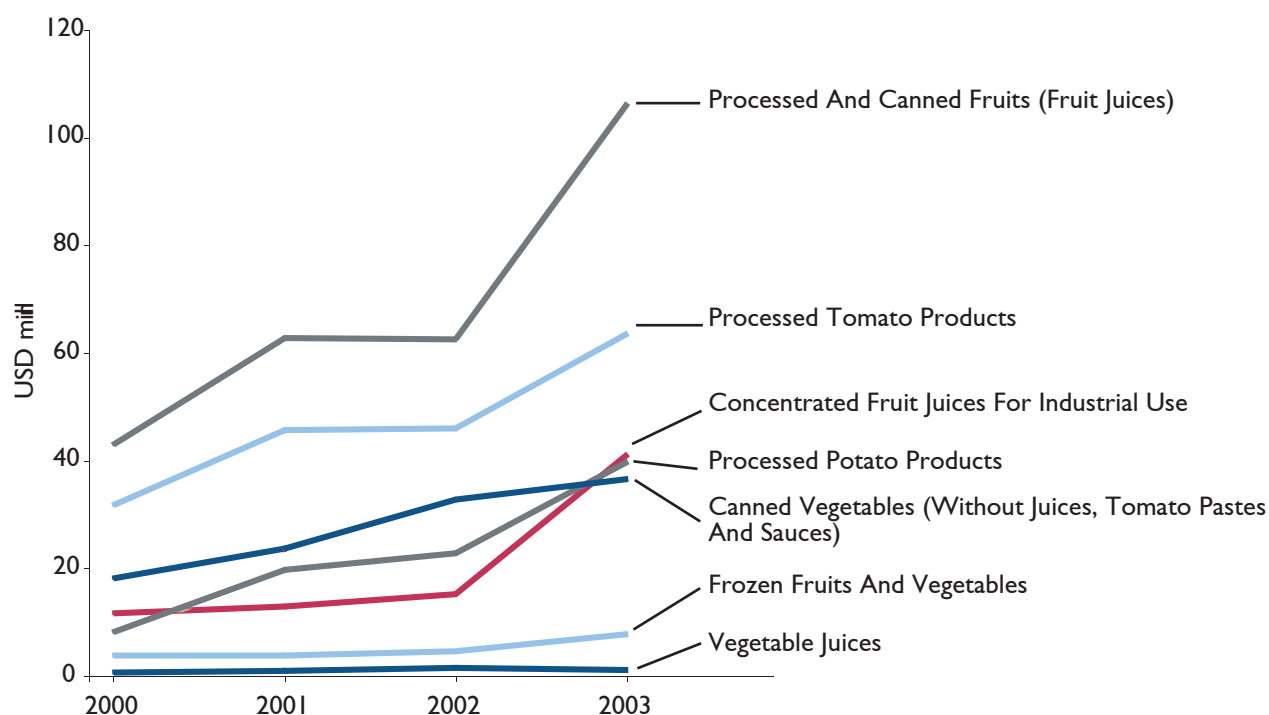
Currently, horticulture accounts for roughly 10 percent of total agricultural production. Virtually all fruit and vegetables consumed in the country (85-90 percent) are domestically produced. The only imported products are citrus and off-season fruits and vegetables. Over the last few years, processing of horticultural products has been growing at an annual rate of 25 percent. Competition among industry players is fierce, and concentration in the industry is very high: the four leading producers together account for 30 to 40 percent of output.

Horticultural productivity is growing as farmers introduce modern farming technologies. For example, the production area with drip irrigation has been increasing (by a stunning 49 percent in 2004).

FIGURE 22: PRODUCTION OF MAJOR VEGETABLES (2003)



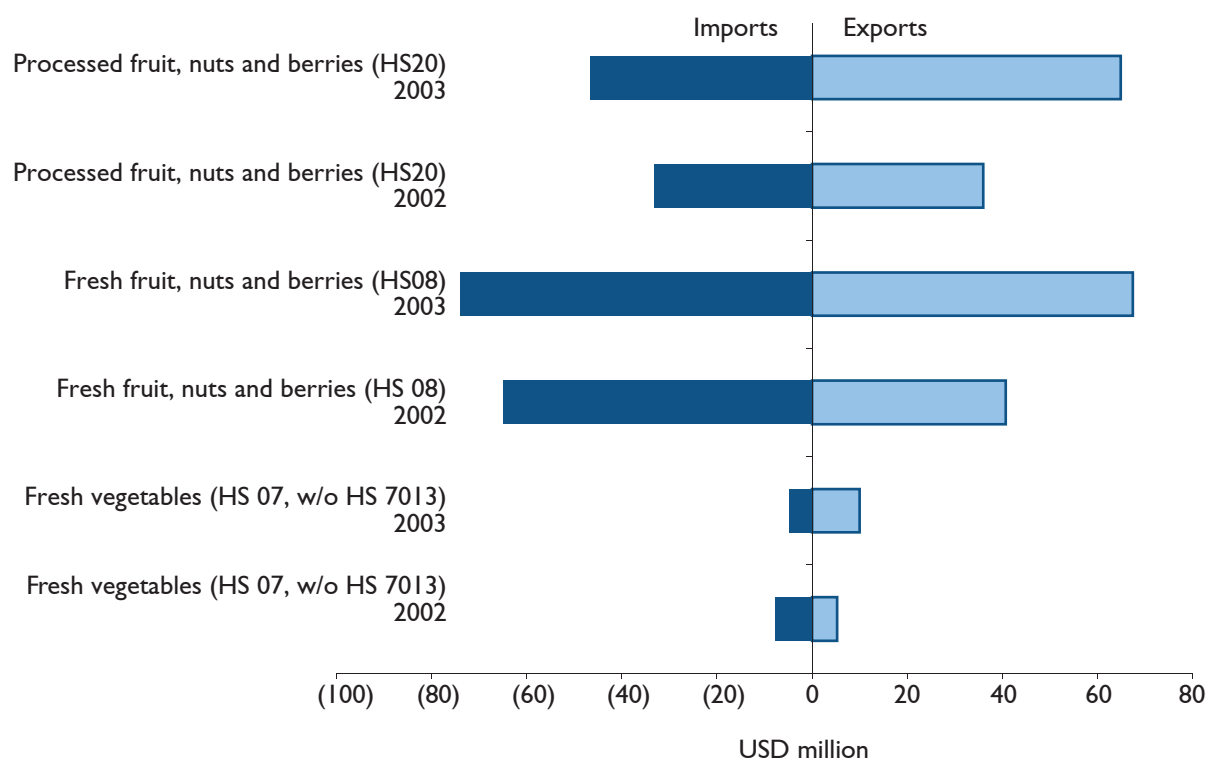
Source: The Agricultural Marketing Project (www.lol.org.ua).

FIGURE 23: PRODUCTION OF PROCESSED FRUIT AND VEGETABLES BY CATEGORY

Source: The State Statistics Committee of Ukraine.

Across all horticultural products, exports account for roughly 22 percent of total production. The share varies from commodity to commodity within the product groups;

for example, roughly 40 percent of juice produced is exported.

FIGURE 24: UKRAINE'S EXPORTS AND IMPORTS FOR FRUITS AND VEGETABLES

Source: GTA.

PROBLEMS AND RESPONSES

High costs of - and limited access to - capital. Growers report fewer problems with funds for working capital, but the lack of long-term funds for capital investment is a major obstacle: agricultural land cannot be used as collateral, and leasing schemes to purchase equipment practically do not work in Ukraine.

Inadequate wholesale/retail trade infrastructure for fresh products. In Ukraine, the wholesale trade of fresh products is inefficient and fragmented: existing wholesalers are small companies that prefer to work in the shadow economy. The chain from producers of fresh produce to end consumers might go through three to four intermediaries, which causes price distortions, lowers farm-gate value, and increases prices to consumers. Storage space for fresh produce is inadequate, and modern storage facilities are lacking. While market information can be obtained quickly over the Internet, many market players have inadequate access.

Ukraine's shadow economy accounts for a major portion of fresh and processed products in the market. The unofficial market for fresh products is significant. Roughly 50 percent of fresh fruits and vegetables are produced by small

households and "dacha" plots unaccounted for in official statistics.

Potential exporters face a lack of resources and qualified staff to begin exporting and prove their reliability to foreign partners. In addition to natural risks which make it difficult to guarantee quality and volume of production delivered each year, the lack of equipment (sorting, packaging, coolers, refrigerators, and term trucks), skills (English language, Customs procedures), and experience in exporting prohibit producers with competitive products from entering or expanding into export markets.

The sector remains exposed to a risky agrarian regulatory environment. Agricultural land cannot be used as collateral (which restricts access to credit), and it is unclear when the land market will be functioning properly. Currently, profits of agricultural enterprises are taxed according to a very favorable single agricultural tax system. Also, agricultural producers benefit from VAT exemption. This taxation system is to be prolonged at the end of every year (currently it's effective until 31 December 2005). There is no guarantee that it will be prolonged further.

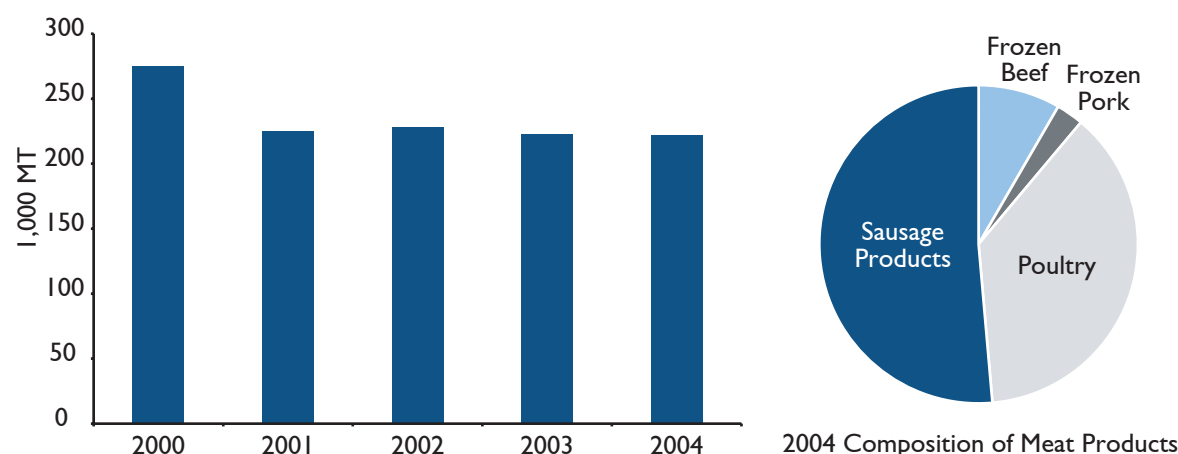
THE MEAT CLUSTER

STATUS OF THE CLUSTER

The meat sector of Ukraine represents a large, vertically aligned industry consisting of small farmers, corporate livestock enterprises, state farms, meat processing facilities, and allied industries. Livestock production is deeply rooted in the Ukrainian lifestyle; family farms and “backyard” businesses account for more than 70 percent of animals raised for meat. Therefore, the overall health of the agricultural complex is closely tied to the small farmer. Furthermore, the general health of small farmers is closely tied to their ability to successfully raise and sell livestock animals.

Meat production has been on a steady decline since 2000, with a peak in production during 2002 followed by a resumption of the decline in 2003 and 2004; see Figure 25. In the years following the heavy liquidation of herds, meat processors have been plagued by low livestock supply and decreasing meat production. Meat production in 2003 and 2004 was reduced as processors struggled to locate adequate raw materials in the country for beef, pork, and sausage production, and total output was down slightly (by 1.7 percent overall).

FIGURE 25: MEAT PRODUCTION AND COMPOSITION (2004)



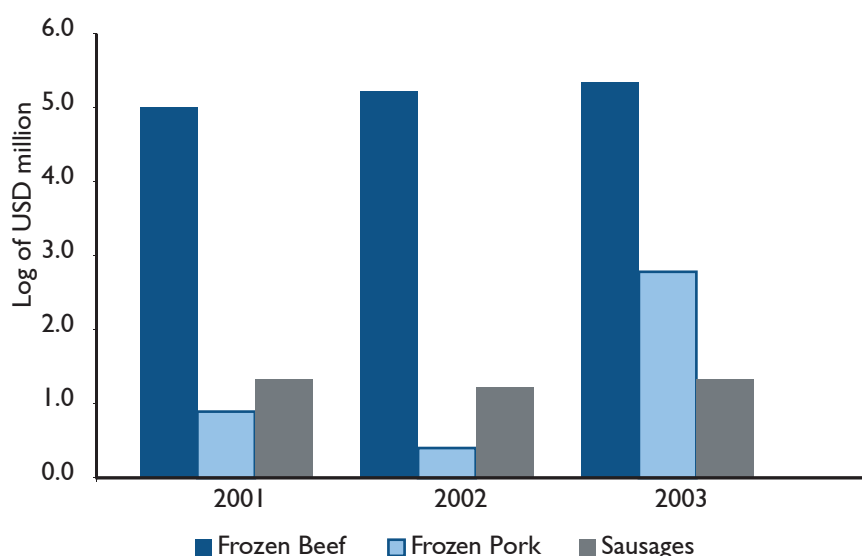
The health of the agriculture sector is generally poor, with a reduction in agricultural GDP of 13 percent between 2001 and 2002. Meat and animal products led the decline, and the profitability of meat processors declined by 14 percent in

one year. Poultry producers and processors were the only sector to report profitability in 2002 with 8 percent gains, whereas the beef and pork sectors posted significant losses.

DEMAND

Ukrainian consumers are estimated to spend between 60 and 70 percent of their income on food products. Meat is an important historical and nutritional staple in the Ukrainian diet, occupying a substantial presence in every meal. The meat of choice is boiled sausage

(41 percent of the meat diet); wieners and frankfurters (23 percent of the meat diet), semi-smoked sausages (15 percent of the meat diet), smoked sausages (3 percent of the meat diet), and smoked meat products represent the balance of meat purchases.

FIGURE 26: MEAT EXPORTS FROM UKRAINE (LOGARITHMIC SCALE)

ISSUES AND RESPONSES

ISSUE: The absence of “meat type” animals for the production of meat and meat products is negatively affecting the quality of raw material used in meat processing, a severe constraint to competitiveness.

RESPONSE: Improving the genetic herd base is an ambitious and long-term proposal, and requires considerable investment, diligence, and creativity. Generation time - the time required for an animal of breeding age to conceive and produce offspring - is a major limiting factor in the beef and swine industries. For cattle, a parallel industry of “beef type” or “meat type” animals needs to be cultured and fostered. In addition, improved swine genetics should be incorporated into progressive breeding programs, using proven and widely available (frozen) semen from Western sources.

ISSUE: The conditions under which animals are raised severely limit animal potential, reduce weigh gains, reduce overall herd health, and increase death losses. Ultimately, poor herd management and herd health may prevent Ukrainian products from accessing international markets.

RESPONSE: Improving standards and modifying management practices involves the transfer of information and training of farmers, which can be provided through consultants or published literature. Rewards for adopting new management styles and techniques are immediate, with reductions in physical death loss, increases in production efficiency, and healthier animals.

ISSUE: Inadequate and poor quality feedstuffs for animal production have severely limited animal quality, fatness, finish, and weight gain. Cattle and swine feeding systems in Ukraine are dependent upon locally grown forages (hay, alfalfa, and straw) and grains (corn, barley, wheat, Milo, and soybeans).

RESPONSE: Unfortunately, solutions to this widespread constraint are limited, empirical in nature, far-reaching, and long-term. Ultimately, however, the agricultural complex must utilize modern farming techniques, increase the use of fertilizers, and upgrade feed manufacturing standards in order to become competitive in the animal agriculture sector.

ISSUE: The Ukrainian herd base for both cattle and swine is rapidly declining and in significant danger of being inadequate to supply the basic meat protein needs of consumers.

RESPONSE: Currently, raising animals (even for dairy products) is highly unprofitable. Farmers are increasingly moving away from animal feeding systems and towards more crop production. Incentives should be developed to encourage farmers to raise animals, increase production efficiency, and improve management practices to become more profitable. Subsidies are not needed to encourage farmers to retain animals for feeding. Loans, availability of capital, and guarantees would provide the stability farmers need to avoid short selling animals and encourage them to increase breeding herds.

ISSUE: The absence of a free market price discovery system for live animals at the time of sale to meat processing companies severely limits the industry's ability to fairly compensate farmers for high quality animals.

ISSUE: The continued presence - and use - of gray channels for marketing, processing, and distributing animals and meat products continues to undermine the integrity of the meat sector and negatively affect consumer confidence in products.

ISSUE: The value chain for meat and meat products lacks a true margin discovery mechanism, and it is unclear if there is adequate margin in the entire value chain to support the industry. Efforts to determine average margins for farmers have been somewhat successful, and it has become clear that the producer subsector is operating at a significant loss (negative margin) of up to 25 percent.

ISSUE: The official use of subsidies paid to farmers for animals within certain weight ranges is distorting the true market status of the industry and providing short-term relief to farmers at the expense of a long-term recovery.

ISSUE: Outdated meat processing technology and inferior processing equipment in processing facilities has put the Ukrainian meat industry well behind Western standards for quality and sanitary production of sausages and processed meats.

ISSUE: The absence of grades or standards for classifying animals and meat products (carcasses and cuts) is preventing value determination on a quality basis. Moreover, the absence of reliable, certified quality assurance laboratories inside the government structure and in private industry is preventing companies from obtaining valuable information pertaining to quality and safety standards of products and facilities.

ISSUE: Throughout the entire value chain of meat production, there is an absence of an integrated cold chain network for transferring raw materials (meat carcasses or cuts) and finished products through the industry.

RESPONSE: Efforts must be strengthened to provide selling options to farmers, including the potential for public auctions and market sales in each oblast whereby farmers are exposed to competitive pricing from multiple buyers and are able to compare their animals (and the prices offered for their animals) with animals from neighboring farms. One possible model is the price reporting networks developed by the Agricultural Marketing Service (AMS) of the United States Department of Agriculture (USDA).

RESPONSE: There is no "quick fix" to this constraint, and efforts to limit the use of gray channels must be addressed at the highest level of the government. Ultimately, it is the responsibility of the regulatory authority to clamp down on unregulated commerce, eliminate the shadow sector or gray channel, and lend credibility to the overall inspection and regulatory system.

RESPONSE: Margin discovery and distribution research should be initiated to determine - using the best information available - the input, overhead, and margin components of each of the subsectors. Furthermore, a fully integrated overview of the margin distribution between the subsectors of the industry is needed in order to determine if there is enough margin potential in the industry to support animal agriculture and meat production.

RESPONSE: Efforts to educate farmers and provide them with sustainable agricultural technologies should be made. Improved feed production, feed manufacturing, animal husbandry, marketing, and common agricultural efficiency will ultimately eliminate the need for artificial market support systems. In the short term, the subsidies are sending a strong signal to farmers to raise better animals, which is positive. However, if the government and industry do not provide the education and information necessary to achieve sustainable change and improvement in the long term, the farmer will ultimately fail.

RESPONSE: There is a large supply of high quality used meat processing and packaging equipment available in Europe and the United States, the result of continual retrofitting of Western processing facilities. It will be necessary for those facilities interested in improving competitiveness to secure access to modern - although not necessarily new - processing equipment that utilizes Western technology.

RESPONSE: Efforts should be made to identify and establish standardized grades for animals, carcasses, and meat products. International grades and standards are available and widely used in commerce, and can be revised and incorporated into Ukrainian law. The government has adopted an internal goal of fostering the development of these independent laboratories, and the industry supports this need as well.

RESPONSE: An integrated cold chain can be built and developed using established resources and networks. There are several groups - including the World Food Logistics Organization (WFLO, www.wflo.org) - that specialize in efforts to develop associations to support an integrated cold chain and technical training to provide the tools necessary to improve the quality, safety, efficiency, and profitability of enterprises in the value chain.

SUPPLEMENT ON AGRICULTURAL EXPORTS

This study has covered two agricultural subsectors: fruit and vegetables, and meat. As a complement to this analysis, this note highlights some trends in agricultural exports to Ukraine's major export markets, the EU 15 and Russia. Figure 27 provides a summary of selected agricultural exports to the EU. Oilseeds play a major role, especially with exports of sunflower-seed oil (HS 151211). Sunflower seeds are technically a "dark star," losing market share in a declining market, but still represent a significant market. Finally, sunflower-seed oil cake is gaining market share in a stagnant market. In addition to the frozen fruit category (bilberries) and apple juice (which were already covered in the discussion of Ukraine's fruit and vegetable cluster),

exports of walnuts may also be worth a second look. Figure 28 offers another look at agricultural exports to Russia. In addition to frozen beef (HS 0202) - already covered in the analysis of the meat cluster - and some market gains in a stagnant market for sunflower-seed oil (HS 1512), the quadrant of "rising stars" has a bit of an "after-dinner" flavor to it. In addition to a relatively small export of vodka and sugar - although both registered a major gain in market share - the two major items are cheese (where Ukraine exported some USD 120 million in 2003 and has been on a path to USD 180 million for 2004) and chocolates. In addition, bread and pastries - essentially cookies - and cordials are also among the commodities of interest.

FIGURE 27: SELECTED AGRICULTURAL EXPORTS FROM UKRAINE TO THE EU 15 (1998-2003)

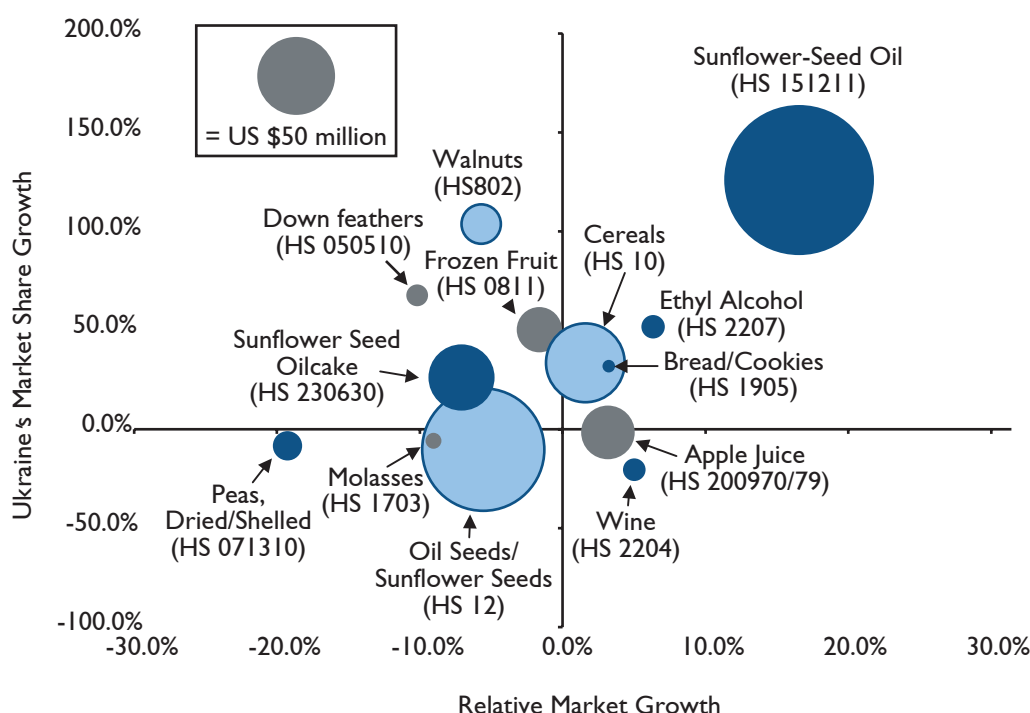
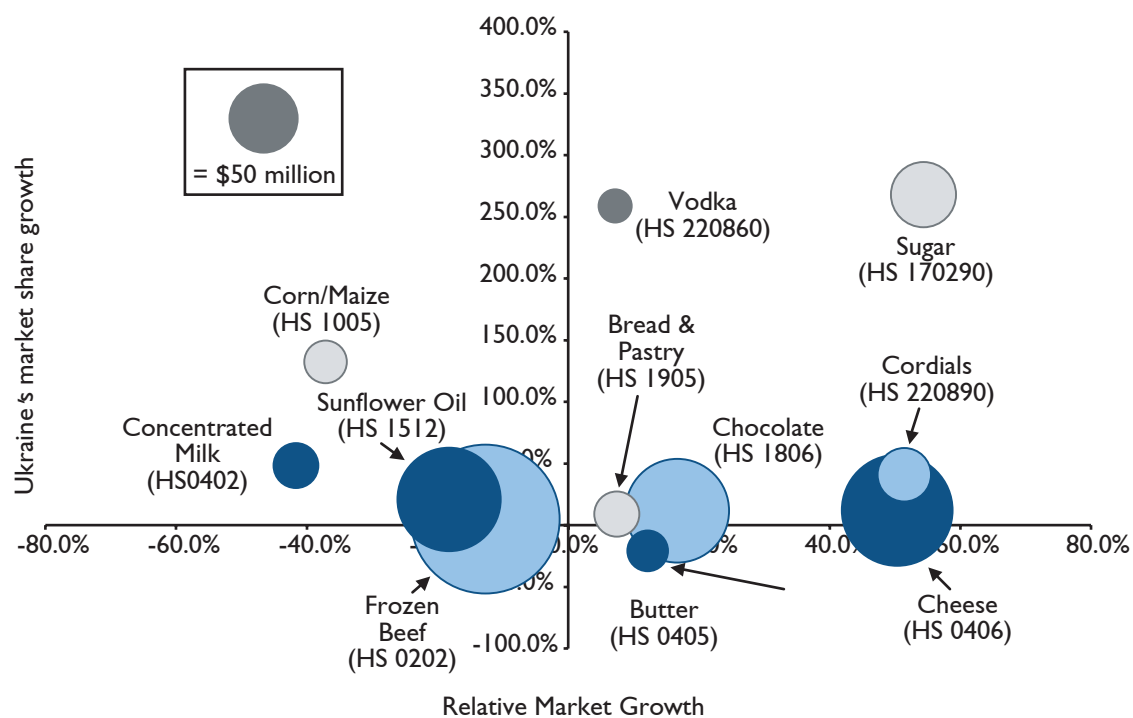


FIGURE 28: SELECTED AGRICULTURAL EXPORTS FROM UKRAINE TO RUSSIA (1999-2003)

THE HIGH-TECHNOLOGY MANUFACTURING CLUSTER

CLUSTER CHARACTERISTICS AND EXPORTS

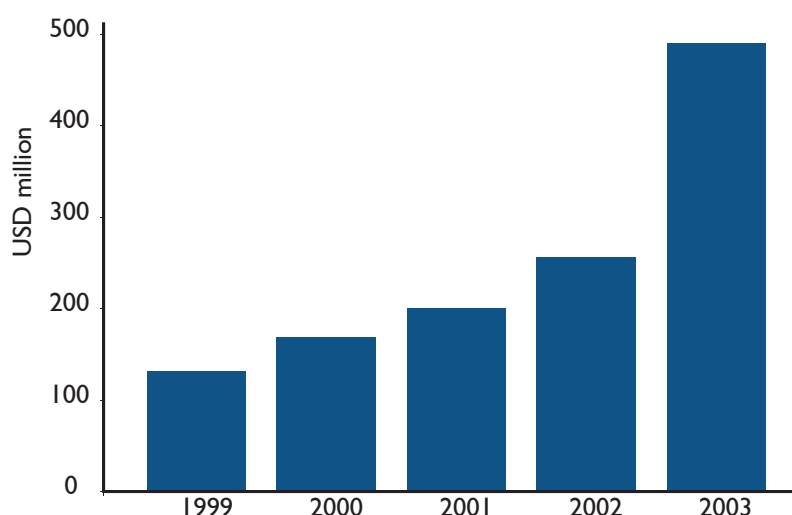
There are no reliable numbers for Ukrainian enterprises operating in the high-tech industries. Computer manufacturing largely consists of assembly of PCs with foreign components by six to ten dominant companies and dozens of small entities. These assembly operations account for more than 90 percent of the total PC market.

The best estimates for total high-tech manufacturing exports are USD 493 million for 2003 and USD 260 million for 2002. The unusually strong growth of high-tech exports of 90

percent in 2003 marks a steep acceleration of the steady export market growth trend that has been underway since 1999, when high-tech exports amounted to only USD 77 million. The following table presents total Ukrainian high-tech exports for the 1999-2003 period.

Russia and Eastern Europe are the primary export markets for most Ukrainian high-tech manufacturing enterprises today, but some Ukrainian firms export to customers in the EU and the U.S. on a more limited basis.

FIGURE 29: HIGH-TECH MANUFACTURING EXPORTS (1999-2003)



Source: The State Statistics Committee of Ukraine.

PRODUCTIVITY

The overall industry data for Ukraine shows labor productivity gains of 86 percent during the past three years. These gains, however, are not so readily apparent in the high-tech sector. The Ministry of Industrial Policy has cited several key constraints:

- insufficient enterprise capitalization;
- tax administration and high tax rates;
- poor access to credit; and
- low innovation activity.

The most critical of these is the first, and lack of foreign direct investment is the core problem. Enterprises must

finance growth through retained earnings, debt instruments, or equity investments. Retained earnings are not nearly sufficient for the high-tech manufacturers. The current National Program of Industrial Development estimates that 67 percent of industry investment requirements would come from retained earnings. Given the current low level of revenue generation in the high-tech industry, that result will not be achieved. Nor are debt instruments sufficient. Rates are high, terms are short, and collateral requirements are beyond the means of most high-tech firms. Investment is essential, especially from foreign investors who can also contribute technology, know-how, and management and marketing skills.

PROBLEMS

All of the enterprises studied for this appraisal have research and development (R&D) departments, even if small in scale

and pared down from earlier days. They also have informal ties with researchers in universities or scientific research

institutions. These personal and professional networks help maintain the interactions required for keeping abreast of technology developments. But the linkages are not robust. Not one of the enterprises contracts research to external entities. At a time when global competitors are building internal research capacity and enhancing internal and external research interactions, Ukrainian high-tech companies are simply trying to “hang on” through informal ties. The result is that very few established enterprises are bringing new products to the market, whether demand-driven or not. With only one exception, all of the enterprises in our sample set that were trying to market new products were start-up companies; the exception had developed only a single new product for a special railway safety application. All of its other communication equipment products need updating. Moreover, start-up companies’ new products are all technology-driven; their products are now looking for customers.

Several enterprise managers in our study sample offered the view that policy concepts were good (including the Technopark incentives) but implementation was poor. But virtually all pointed to the need for investment capital and the need to overcome the deterrents to FDI noted under the performance constraints section.

Three main conclusions can be drawn from the priorities noted by the Ukrainian high-tech manufacturing enterprise managers:

- (1) The need for investment capital is paramount. The removal of obstacles to FDI cannot be avoided if the high-tech manufacturing industry is to grow and become globally competitive. Seven of fourteen enterprises pointed to investment capital as their number one need, and another three placed it in the second position.
- (2) The need to improve the business environment through policy measures and legal and regulatory reforms is also essential. Eight of fourteen enterprises identified specific legal or regulatory barriers as either their first or second priority problem.
- (3) Industry managers need strategic marketing partners or other forms of marketing services. This conclusion was not unexpected. Leading global high-technology companies view the formation of “alliances, partnerships, or joint ventures as a more important business strategy” than low-technology companies. Seven of fourteen enterprises identified some type of priority marketing need.

RESPONSES

Generally, the high-technology manufacturing sector is most vulnerable to the obstacles to FDI caused by the weakness of the investment climate. Efforts to address these weaknesses and attract FDI therefore will have a direct impact on this cluster.

Private enterprise leaders must emerge and help develop the voice of the private sector. These leaders must also set the agenda for achieving results in the two critical gaps. Increasing the competitiveness of the high-tech manufacturing cluster can be realized, therefore, through work in three key areas:

- (1) engaging and supporting private sector leaders to develop cooperative mechanisms to advance the common needs of the high-tech industry at large and those of its various components;
- (2) building consensus and executing an action plan to close the innovation capacity gap; and
- (3) building consensus and executing an action plan to close the policy incentives gap.

The action plan requirements for the high-tech manufacturing cluster can be defined within the context of the science and technology linkages model.

1. Strengthen enterprise linkages with universities and scientific research institutes.

There are a variety of “facilities-based” mechanisms that could work in Ukraine, ranging from joint research laboratories to centers of excellence to regional technology development centers. These efforts would be complemented by a number of “human-based” initiatives, including:

- “externship” programs for students and faculty members;
- “continuous improvement” user groups;
- “networking” events to bring together enterprise managers and engineers with academic researchers and venture capitalists; and
- industrial licensing programs and/or exchanges.

2. Strengthen market linkages with a focus on contract manufacturing, strategic alliances, and investment partners.

The high-tech manufacturing enterprises are not currently working through trade or business associations to undertake collaborative industry development initiatives. There is little or no interaction among the cluster stakeholders. Market linkage initiatives should focus, therefore, on meeting these needs, including specific opportunities for trade associations:

- participation in high-tech manufacturing trade exhibitions;
- participation in key industry technical conferences;
- organization of global stakeholder missions to Ukraine; and
- organization of Ukrainian “venture fairs.”

3. Set “smart privatization” and post-privatization restructuring policies as a clear second priority for the high-tech manufacturing cluster policy agenda.

High-tech trade associations led by private sector champions must help address the larger investment issues for the cluster by conducting a thorough review of the

shortcomings of current policies, laws, and regulations from the perspective of reducing FDI risks. They must also establish mechanisms for addressing the issues specific to individual members.

4. Set new high-tech venture start-up needs as a third priority for the high-tech manufacturing cluster policy agenda.

Start-up companies have special needs in any location. Though most new ventures fail, the process of “churning” is critical to high-tech manufacturing cluster growth. The high global growth rate for the industry today is fueled by the

constant emergence of new companies, and that process spurs the entire industry to higher levels of competitiveness. The principal needs to support the process of new company formation are:

- investment capital;
- management and marketing assistance;
- financial credits;
- strategic partners; and
- skilled human resources.

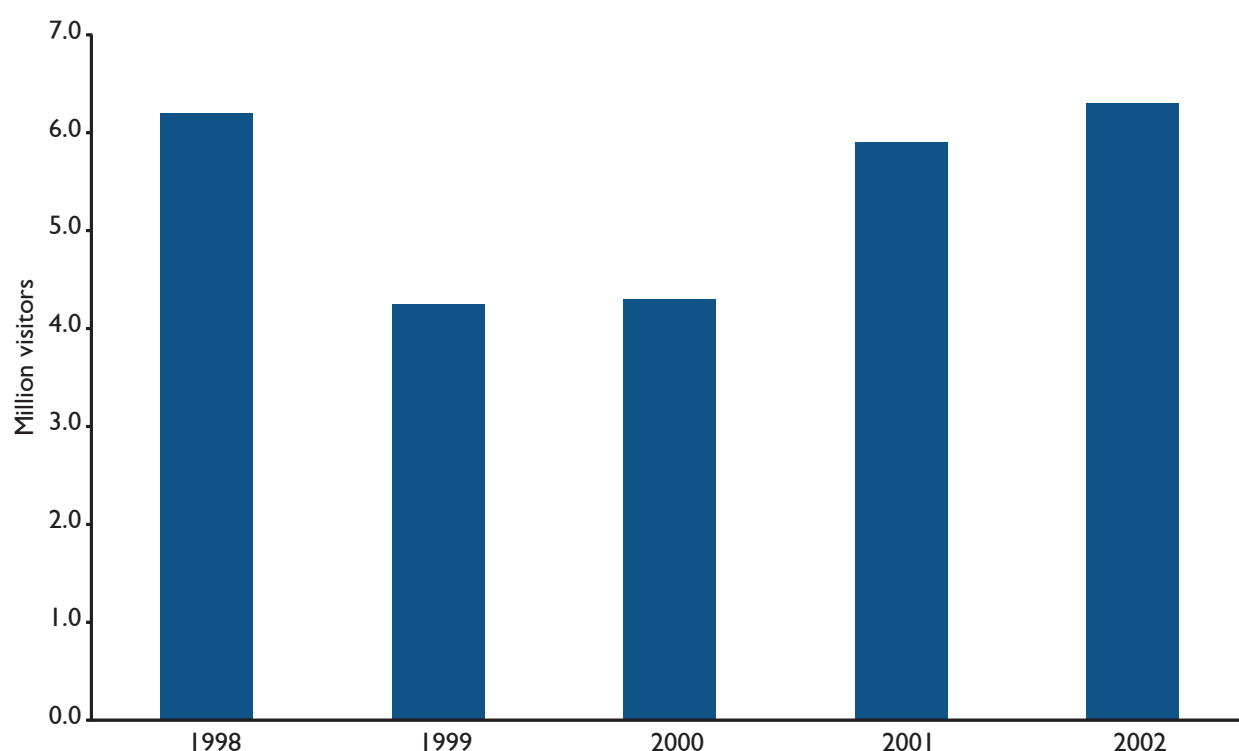
TOURISM IN THE CRIMEA AND THE CARPATHIAN MOUNTAINS

TOTAL SIZE OF THE TOURISM CLUSTER

According to the data collected by the World Tourism Organization (as shown in Figure 30), total tourist arrivals to Ukraine have climbed back to the levels seen prior to the Russian financial crisis. Since 1999, arrivals to the whole of Ukraine have been increasing at an average annual rate of approximately 14 percent.

With this level of industry growth the increase of foreign and domestic investments is expected. Interested investors can consult BIZPRO's recently published *Investor Roadmap of Ukraine*. The Roadmap provides practical information on how to invest in Ukraine, and specific information for investing in the tourism sector in the Carpathian Mountains.

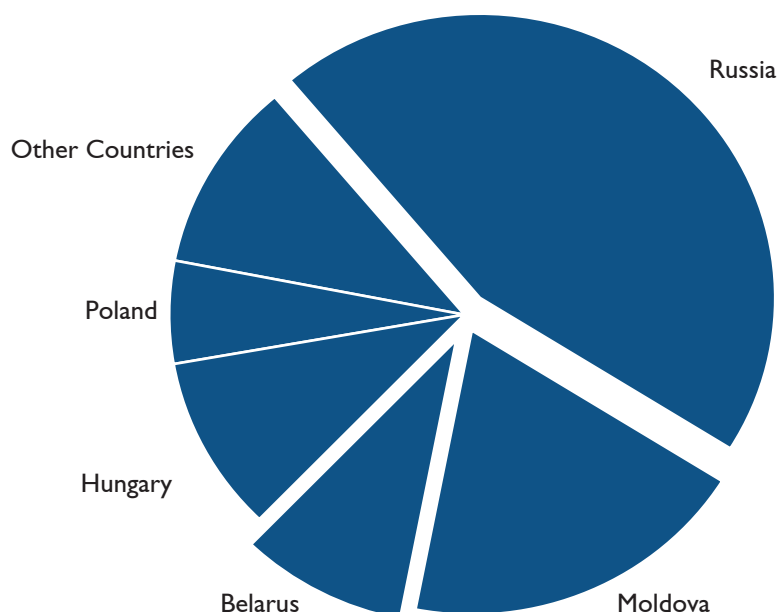
FIGURE 30: TOTAL TOURISM ARRIVALS (1998-2002)



Source: The World Tourism Organization.

Total expenditures by international tourists have been estimated at EUR 3.2 billion (USD 3.8 billion) for 2002, an increase of 4 percent over 2001. With the 2002 number of arrivals estimated to be 9 percent above that of 2001, Ukraine's visitors spent 5 percent less than the year before - either as a result of shorter stays or generally lower expenditures. The average visitor spends about four days in-country, and contributes about USD 600 to the economy. Some estimates put per visitor expenditures at between USD 555 and USD 612, with average lengths of stay varying between 2.6 days and 4 days. One-day tour prices in 1998 were estimated to be between USD 82 and USD 99.

The most popular destinations are Kyiv (30 percent of arrivals), the Autonomous Republic of Crimea (30 percent), the Carpathian region (including Lviv; about 20 percent), and Odessa. Figure 31 shows that most of the tourists are coming from the neighboring countries of Russia, Moldova, Belarus, and Poland; over the past five years, the share of Russian tourists has increased, indicating that tourism in Ukraine is becoming more dependent on a single market.

FIGURE 31: COMPOSITION OF TOTAL TOURIST ARRIVALS BY COUNTRY OF ORIGIN (2002)

While tourism remains important to the Ukrainian economy, its structural characteristics suggest that efforts to boost competitiveness by extending the average length of stay, increasing per visitor expenditures, and intensifying efforts to expand its presence in new markets can yield significant

returns. This assessment looks at tourism in the Crimea and the Carpathian Mountains to explore the dimensions of such efforts. The assessment included interviews with key informants, and a workshop bringing together selected stakeholders.

THE TOURISM CLUSTER

It is impossible to look at tourism through anything other than a cluster lens. All elements - access to information, the reception at the border, transport, hotel facilities and services, restaurants, and activities - combine to produce the ultimate product, the tourist experience. A five-star hotel experience can be marred by a one-star taxi experience: the overall product - client satisfaction - falls short of

competitive standards. Generating a satisfactory experience and marketing the regional product as a whole calls for some form of cooperation, even as the elements of the cluster compete for customers. How tour operators capitalize on the “unique selling points” (USPs) of the region, relate to global markets and market architectures, and tie into the local economy shapes the overall development impact.

A CHANGING MARKET ARCHITECTURE

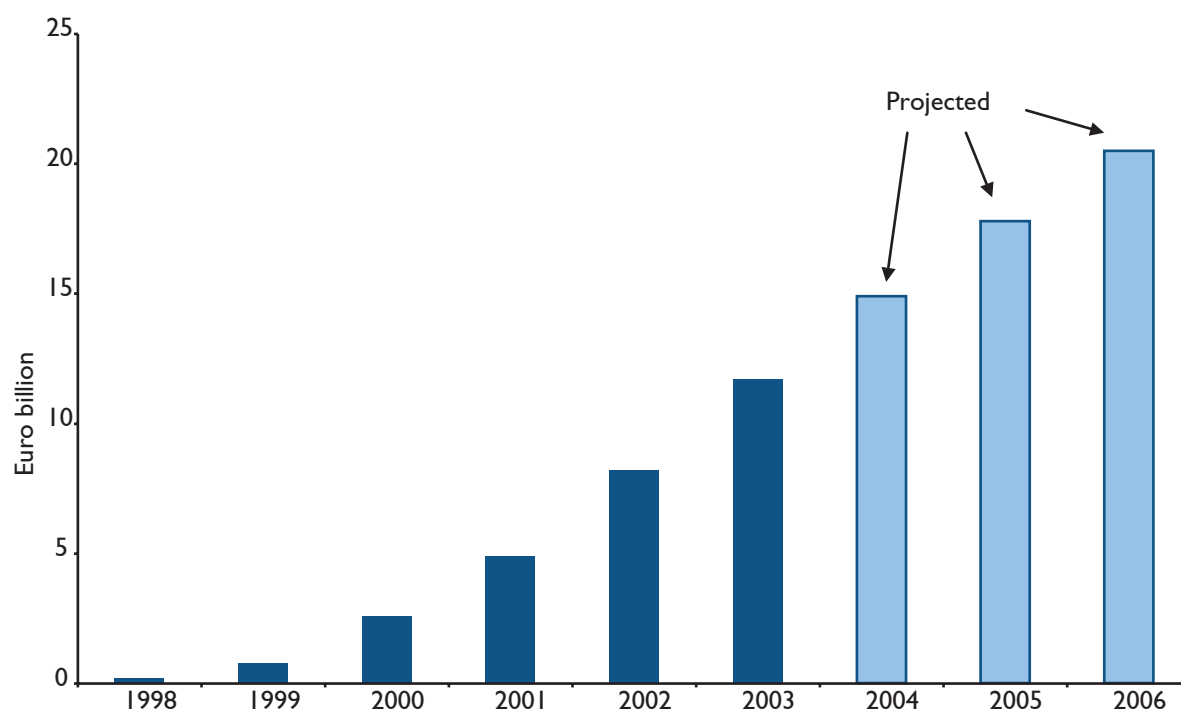
While the worldwide travel market has been growing at modest rates, the size of the on-line travel market has been exploding, as Figure 32 shows. In the U.S., the size of the on-line travel market rose by 85 percent between 2001 and 2002, while total travel in the wake of 11 September 2001 declined by 10 percent. More than 35 million Americans purchased travel on-line in 2003; 86 percent of on-line

travelers shopped multiple sites, and 45 percent of on-line travelers bought *all* of their travel on-line.

These shifts in market architecture have direct implications for reaching customers for Ukrainian tour operators. They offer both an opportunity and an obstacle to accessing new markets and attracting a different clientele.

FIGURE 32: INTERNET PENETRATION IN TRAVEL BOOKINGS, EUROPE

Size of on-line travel market, Western Europe



Source: Carl H. Marcussen and the Centre for Regional and Tourism Research (www.crt.dk).

TOWARD CLUSTER DEVELOPMENT IN THE CRIMEA

A formal tourism cluster does not currently exist in the Crimea. However, given the relatively diverse membership of the Crimea Association of Travel Agencies (CATA), it might emerge as the leader for a cluster-oriented initiative.

CATA was founded in 1997, when the tourism market in the Crimea was beginning to gather momentum as more of a private sector-driven industry. CATA has played a critical role in bringing more than 100 enterprises and entrepreneurs together to lobby the government on behalf of the industry. In addition, CATA has served as a source of expertise and training to increase professionalism among its members. However, in the absence of a clearly articulated strategy supported by a range of stakeholders, its lobbying efforts have produced little of value.

Our assessment identified the lack of cooperation among industry players and with governmental authorities as a critical issue, along with the following priority issues:

- the state is not an effective owner and manager of resorts, yet it retains a high percentage of facilities, contributing to lower expectations;
- there is a lack of transparency between and among both public and private sector players;
- new fora are required to improve public-private sector relations and cooperation in the design and implementation of strategic approaches;

- the recently adopted national tourism law primarily reflects the interest of large-scale operators and disadvantages SMEs; and
- half of the visitors to the Crimea stay in unregistered and uncontrolled private accommodations.

There is an opportunity to help in cultivating the private sector's leadership and institutional capacity for improved public-private cooperation by articulating a common cluster development strategy and coalescing efforts around clearly defined priorities. That focus could then be complemented with training, advocacy, and communication skills development, as well as increased development of local business service providers.

In particular, the following types of support seem to be urgently needed:

- (1) The development of effective strategies depends on improved market knowledge. There is a serious need for capacity building in market research and statistical systems. This capacity building could be undertaken with government authorities as well as with civil society organizations such as the Yalta Management University, the Crimea Association of Travel Agencies, and selected business service providers. These efforts would also include cooperation with the World Tourism Organization.

- (2) Technical assistance to the principal industry association, CATA, could assist the industry in maximizing the use of better research and knowledge for the improvement of their businesses and the Crimean tourism industry and economy overall.
- (3) Outside intervention could serve as a catalyst for building on improved market knowledge and understanding of competitive trends to promote increased private-public sector cooperation with an eye on the development of an effective strategy. Strategic priorities include: strengthening linkages in the value chain, branding, repositioning towards specialty travel products, and increasing staff quality.
- (4) Technical assistance is needed to work with CATA and other interested groups in adapting more aggressively to emerging market trends - particularly the Internet's penetration of the global tourism market.

SUPPORT OPTIONS TO THE TOURISM CLUSTER IN THE CARPATHIAN MOUNTAINS

It is obvious that the tourism potential of the Carpathian region is not being realized. Any increases in either foreign or domestic arrivals do not appear to be the result of a concerted effort from either the public or private sector, and occur despite the chokepoints noted below.

- (1) *Validity of tourism statistics.* The presentation of tourism statistics both regionally and nationally does not follow international norms. Additionally, the erratic results provided by the oblast administrations and State Tourism Administration suggest weaknesses in the methods of collection. The effects of intervention, policy changes, and strategy cannot be measured until a reliable system of data collection is established.
- (2) *Image and destination awareness.* The Carpathian Mountain brand is weak, inaccurate, and unrecognized. A heavy focus on natural resource endowment does not realistically represent the region's best assets and makes competing with neighboring regions difficult. There is little concept of market research and investigating market demand. Promotion is limited, and promotional materials do little to support a brand. The region has a wealth of tourist attraction treasures, but they remain buried.
- (3) *Public sector capacity.* The public sector is decentralized, yet suffers from lack of direction and strategy. Oblasts work apart as competitors rather than combining efforts. Budgets are limited, and the focus is on infrastructure and investment. The mentality of controlling the private sector remains.
- (4) *Private sector professionalism.* Private sector companies are focused particularly on the less demanding - but also less profitable (per tourist) - domestic market. The prevailing Soviet mentality means that a transition to catering to foreign visitors will be difficult, and will require a new style of management and business. The necessary skills of segmentation, product development and packaging, and promotion and marketing need to be gained. Safety may become an important issue.
- (5) *Private sector associations.* The number of tourism-related associations in the region is an indication of a desire and willingness to cooperate, although they all suffer in effect from a lack of strategy, a top-down approach, and a collective incapacity to achieve anything substantial. Conflict between associations is expected in the long term.
- (6) *Poor quality and low levels of service.* Although some entrepreneurship is increasing the quality standards of bed-and-breakfast accommodations, levels of service are not keeping up with the pace of change. Quality is lacking in accommodation (a lack of higher quality accommodation) and souvenir production. Value for money remains poor, and levels of service at tourist attractions, museums, hotels, and restaurants require specific attention.
- (7) *Infrastructure.* The poor quality of airport infrastructure may act as an obstacle to successfully increasing the number of incoming flights to the region. The speed of trains may deter travelers arriving in Kyiv from traveling to the region.
- (8) *Accessibility.* This is an issue not so much in terms of accessibility to the region, but rather in terms of the genuine culture of the region and information about it. Tourists are not able to gain a deep understanding of Hutsul culture and its elements, although they exist. Information on the region in Internet and printed formats is limited.
- (9) *Support industries.* No connection or relationship with essential support industries - including equipment stores, rental outlets, insurance companies, and training institutions - exists.

The following activities are designed to address key chokepoints:

- Assistance to the State Committee for Tourism, oblast administrations, and supporting organizations in the collection and analysis of tourism statistics.
- Technical assistance to the public and private sectors directed at and through the Carpathian Tourism Board in order to develop long-term strategies and policies along with training (destination marketing and cultural promotion, branding, and event management). The Board needs to alter its structure and membership to incorporate a greater diversity of cluster representatives. The Carpathian Tourism Board must be the foundation for assistance, since it already incorporates the four oblast administrations and a large number of varied representatives of the private sector.
- Particular attention should be directed to defining the public and private sectors' roles more clearly through the Carpathian Tourism Board. Working through the

Board in providing general training to public sector staff and private sector firms will build the reputation and capacity of the Board and therefore strengthen its role.

- Work closely alongside the Rural Green Tourism Association in boosting capacity. The association needs a full-time staff member to handle bookings, administrative responsibilities, promotional work, training, and inspection and certification. Assistance is required to review association structure and (if necessary) provide short-term funds to employ a member of staff and undertake promotional activities until the association becomes more financially sustainable. Stronger links must

be created between the Carpathian Tourism Board and the Rural Green Tourism Association. Moreover, the Association needs specific expertise in penetrating the new market architecture for tourism, especially through the expansion of its Internet services.

- Assistance to individual enterprises in specific business management activities, particularly those bed-and-breakfast owners tempted to make improvements to their services and accommodations, and tour operators attempting to branch out into or focus on new geographic or activity-based markets.